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REVIEW OF THE FEDERAL ENERGY REGULATORY COMMISSION'S ORDER NO. 436

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
ENERGY REGULATION AND CONSERVATION

OF THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

TO REVIEW THE FEDERAL ENERGY REGULATORY COMMISSION'S ORDER NO. 436, FINAL RULE AND NOTICE REQUESTING SUPPLEMENTAL COMMENTS ON REGULATION OF NATURAL GAS PIPELINES AFTER PARTIAL WELLHEAD DECONTROL

WASHINGTON, DC, NOVEMBER 21, 1985
TULSA, OK, NOVEMBER 27, 1985

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REVIEW OF THE FEDERAL ENERGY REGULATORY COMMISSION'S ORDER NO. 436

THURSDAY, NOVEMBER 21, 1985

U.S. Senate,
Subcommittee on Energy
Regulation and Conservation,
Committee on Energy and Natural Resources,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room SD-366, Dirksen Senate Office Building, Hon. Don Nickles presiding.

Present: Senators Nickles, Murkowski, Hecht, Bumpers, Ford, Metzenbaum, Bradley, Bingaman, and Rockefeller.

Also present: Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator Nickles. Good morning. Today is the first of 2 days of oversight hearings on the Federal Energy Regulatory Commission's Order No. 436. The second day is scheduled for November 27, in Tulsa, OK.

As I'm sure everyone is aware, Order No. 436 created a voluntary natural gas transportation program that has enlisted few volunteers. Of the 128 interstate pipelines that filed tariffs with the Commission, only 11 have agreed to participate, many of which are relatively small pipelines. Only 4 of the 20 largest interstate pipelines are now participating, and it is not clear how many of these will continue to participate beyond December 14, the last day of the 45-day transition period.

Although Order No. 436 was intended to get pipelines to voluntarily provide transportation services to move natural gas from producers to consumers, it has instead had the opposite effect. I am very concerned about the lack of pipeline participation after the 45-day transition period ends on November the 14. Reading from the Federal Energy Regulatory Commission's news release dated October 9 the FERC Chairman stated that: "Our goal in this landmark rule is to give natural gas consumers more option for gas supplies." Now that certainly is not the result of this order. In that announcement, FERC Chairman O'Connor also says: "In turn, producers for the first time will gain access to pipeline capacity to market their supplies directly to consumers and new markets."

And certainly that is also not the result of this order. It may have been the intention, but it certainly is not the result.

Pipelines are now transporting less gas than before the new program went into effect, and as a result, producers are being forced to shut in gas production that otherwise could be marketed. I know of many producers located in Oklahoma and elsewhere who have now gas wells shut in because pipelines are not transporting gas for them as a result of this rule.

I expect to get a better idea of that situation today. I also hope to find out exactly why pipelines are unwilling to participate in this program. This will enable the Committee to assess the reasons for the lack of participation, and to determine what future legislative steps, if any, need to be taken.

In my opinion, the FERC has gone way beyond reasonable action with its latest rulemaking. Obviously the necessary incentives to make the new rules work fell far short of reality. Not only has the FERC hurt producers, but also they've hurt consumers and I personally hold the Commission responsible for whatever economic ruin and displacement it has caused by its regulatory bungling.

It is essential that pipelines make transportation services available on a nondiscriminatory basis so that residential, commercial, and industrial gas consumers can be assured access to supplies of natural gas. A viable transportation program also helps producers find a market for gas that otherwise would be shut in. It encourages competition in the natural gas market, and it helps hold down the price of gas to consumers. In short, a workable transportation program is in everyone's interest.

That's why, on November 7, I introduced Senate Resolution 255, along with Senators Domenici, Dole, Boren, and Gramm. The lack of pipeline participation is a clear indication that the FERC needs to make significant changes in its program in order to get pipelines to participate. In my opinion, unless and until more pipelines agree to participate, we will have on our hands a growing crisis in the natural gas industry.

Today's hearing is also about the Commission's so-called block billing proposal. Although Order No. 436 did not adopt the block billing proposal contained in the original NOPR, it was modified and the Commission requested further comments on it.

I am absolutely and totally opposed to the Commission's block billing proposal. In my opinion, block billing would be the worst of all possible worlds. It would take away incentives to explore for new and develop new supplies of natural gas that are needed to replace existing reserves that are being depleted through consumption.

Block billing would provide no incentives to increase production from old gas reservoirs. Thus, it would increase our dependence on insecure supplies of foreign energy. Moreover, block billing would not level the playing field, as is claimed by the Commission. It would just tilt the playing field in a different way, creating new winners and many new losers.

It would, in my opinion, greatly distort and disrupt an already chaotic natural gas market, and would cause massive abrogation of contracts. I strongly believe that the FERC does not have the statutory authority to implement block billing.

At the subcommittee's September 18 hearing on the Commission's NOPR, there was nearly unanimous statements by pipelines and producers that block billing is a bad idea and would not work. I also plan to testify before the FERC on December 11 on the block billing proposal.

We have several outstanding witnesses today, and I am also aware that we have several Senators who will be joining us in the not-too-distant future. We were in session last night until about 11 o'clock, so that may be the reason why some aren't here. But I've had several of our colleagues contact us that they wanted to be with us, and I am appreciative that Senator Bingaman has joined us today, and we also have my colleague and good friend, Senator Boren, with us today.

Senator Bingaman, do you have any opening remarks?

STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator **Bingaman**. Mr. Chairman, I just appreciate you holding the hearing. I know there are some excellent witnesses here. I think the Senators who aren't here yet probably made the mistake of trying to go home between the close of last night and the start this morning.

I look forward to the testimony. I think the issue you're focusing on, the pipeline transportation of natural gas and block billing, both are crucial issues in my home State of New Mexico.

Senator **Nickles**. Thank you very much.

Senator Boren, did you have any opening comments?

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator **Boren**. Thank you very much, Mr. Chairman.

Again, I want to commend you for holding these hearings. Obviously this is a matter of grave importance to us in our part of the country. I notice that currently many pipelines have terminated purchases of natural gas formerly moving on the spot market, and in just checking the figures, recent estimates place the amount of shut-in gas in Oklahoma to be between 300 and 600 million cubic feet per day.

This is resulting in a loss of $1.2 million in income per day, and of course this impact further jeopardizes the already fragile relationship—I think that's the way to describe it—between natural gas producers and their bankers and the financial system.

So meager drilling budgets will be slashed, and cash-flow is going to be constricted further, impacting the State government as well. The result of this action will see residential consumers who are expecting to benefit from cheaper gas paying higher prices in the long run, I am convinced. Because, after all, if we cannot make the drilling and exploration and production cost effective, we're going to have a very shortsighted policy in the name of consumerism that's going to produce severe shortages in the future.

So I'm very hopeful that as a result of the actions of this committee and the information that will come forward today we will have the rule held in abeyance while we can work toward an overall comprehensive solution, and one that will provide fair access for the producers and ultimately the deregulation of all natural gas, and the repeal of the unwise Fuel Use Act and the other things that need to be done in a comprehensive way to set the industry back on the right track.

As the chairman knows, to describe what we're going through in Oklahoma right now as a depression is not an exageration, and the confusion caused by the current situation is certainly not something that we need piled upon the economic problems that we're already having.

So I look forward to listening to the testimony today, and again I just want to commend you for taking the lead in calling this series of hearings.

[The prepared statement of Senator Boren follows:]

Prepared Statement of Senator David L. Boren

Mr. Chairman, I would like to thank you for the opportunity to participate in today's hearings. Let me say from the outset that I am very concerned with FERC Order No. 436. The effect of this rule has been to severely disrupt an already depressed natural gas market.

Currently, many pipelines have terminated purchases of natural gas formerly moving on the spot market. Recent estimates place the amount of shut in gas in Oklahoma to be between 300 million and 600 million cubic feet per day. This has resulted in $1.2 million in lost revenues to the producers per day! This impact further jeopardizes the already fragile relationship existing between many producers and their banks. Meager drilling budgets will be slashed as cash flow is constricted further. The end result of this action will see residential customers, who are expecting to benefit from the cheaper gas, paying higher prices for natural gas.

I have no reason to believe that this was the intended result of Order No. 436, however, it is in fact occurring and the situation is becoming desperate. While we of course want to get gas to the consumer at desperate. While we of course want to get gas to the consumer at reasonable rates, we must first produce the gas. If it is not cost efficient to find the gas then sooner or later there will not be an industry left to regulate. A short sighted policy in the name of consumerism will produce a severe shortage in the future that will hurt the entire nation, especially the consumer.

Therefore, I would urge FERC to suspend the enforcement of Order No. 436 and return the natural gas industry to the previous status quo. This would allow us the opportunity to work toward a comprehensive solution that must provide fair access to transportation for producers, the deregulation of all natural gas pricing, and the repeal of the Fuel Use Act.

Senator Nickles. Thank you very much, Senator Boren. We welcome you to our hearing, and you're welcome to participate throughout the morning, if you wish.

Senator Rockefeller, did you have an opening statement?

Senator Rockefeller. I don't have an opening statement, Mr. Chairman, but I know it's going to be a good hearing because you have a West Virginian here, Stan Pickens, and he's on the panel. So I look forward to him and the other members.

Senator Nickles. Thank you, Senator Rockefeller.

Senator Metzenbaum, did you have an opening statement?

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator Metzenbaum. Yes; I do. I want to thank you for setting up this hearing, because there are a lot of old friends whose faces I haven't seen for some time around here, and they've all come out this morning, and it's nice to see all of them again. [Laughter.]

It seems to me that some of the music and the refrains are a little bit different, but generally speaking it comes out about the same kind of orchestration.

When FERC issued Order No. 436, it set in motion truly revolutionary changes in the marketing and distribution and sale of natural gas. Now the rule is not perfect, but it offers a framework for injecting genuine competition into the gas industry for the first time ever.

For this reason, I am disturbed that most interstate pipelines have chosen not to participate in the interim transportation program. Now I've listened to their reasons for refusing, and I don't mind saying, Mr. Chairman, that frankly I am totally unpersuaded by them.

I have listened to them say that they actually support nondiscriminatory access, but favor a legislative solution that addresses the take-or-pay problem, as well. This might more properly be described as a deathbed conversion to support of nondiscriminatory access which strikes me as being disingenuous. After all, these are the same people who opposed the Bradley contract carriage bill 2 years ago, and who encouraged FERC to discard the take-or-pay fix contained in the original NOPR.

Calling for a legislative solution is tantamount to endorsing the status quo. There is as much chance that Congress will pass gas legislation as there is that I will be named oil man of the year. [Laughter.]

We look forward to that event. [Laughter.]

Senator **Boren**. We'd love to give you a chance to qualify. [Laughter.]

Senator **Metzenbaum**. I'm afraid that some may want to call me the "big gasser," or something. [Laughter.]

But when all the rhetoric and posturing is set aside, I believe the fundamental reason that pipelines have refused to participate in the FERC program has nothing to do with the take-or-pay issue. Rather, it has to do with the fact that pipelines just don't want the risks of living in a competitive market. Their dreamworld is one where parties are denied access to transportation, not one where there is genuine access.

Today we are introducing a resolution calling on pipelines to participate in the FERC transportation program. Instead of waiting around for legislation, I suggest the pipelines take the challenge FERC has issued to enter the brave new world of competition.

I want to make one final comment on the Department of Energy's proposal to increase the just and reasonable rate of old gas. That proposal is a crude effort to accomplish through rule what Congress has refused to do by law. That is, decontrol old gas. Make no mistake about it, the Department of Energy and others may couch this in terms of an adjustment in just and reasonable rates, but it is really backdoor administrative decontrol.

I would point out that Commissioner Trabandt stated in sworn testimony before this committee that he would not support deregulation of old gas through the rulemaking process. Commissioner Nave told this committee he would not support an exercise of the NGPA just and reasonable authority absent a clear and public interest showing.

I believe both these Commissioners were fully aware that they were being asked whether they would support a proposal of the sort put forward by DOE. If they do support it, I would consider it a breach of their commitment to this committee.

In sum, Congress has said no again and again to old gas decontrol by whatever name. I would say to the administration, to FERC, and anyone else who would use the rulemaking process to achieve old gas decontrol, go ahead and try it. Make my day. [Laughter.]

Senator **Nickles**. Senator Metzenbaum, it's always a pleasure to have you with me on this committee. [Laughter.]

I'm going to work real hard to make sure you stay as ranking minority member in this committee. [Laughter.]

Senator **Metzenbaum**. Mr. Chairman, I must confess that I have a strong interest in this issue, and I don't know whether I ought to be going to the other committee that I must attend, or stay here. The other committee is dealing with the issue of capital punishment, and I'm not sure. [Laughter.]

Please excuse me.

Senator **Nickles**. These are life and death matters, that's true. We welcome you, if you can make part of this meeting.

Senator **Metzenbaum**. I will try to come back.

Senator **Nickles**. Thank you.

We do have several outstanding panelists, and we're going to request that all of our panelists would go through and make their statements. We're going to request all of our panelists today to try to maintain their oral comments within a 5-minute period. All statements of course will be entered into the record. So if oral summaries or comments can be made within the 5 minutes, that would certainly be appreciated.

Our first panelist we have is Dave Hentschel, chairman of Cities Service Oil & Gas Corp., and also chairman of the Natural Gas Supply Association, from Tulsa, OK.

Mr. Hentschel.

STATEMENT OF DAVID A. HENTSCHEL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CITIES SERVICE OIL & GAS CORP., AND CHAIRMAN, NATURAL GAS SUPPLY ASSOCIATION, TULSA, OK

Mr. **Hentschel**. Good morning, Mr. Chairman, and members of the subcommittee.

I am appearing before you today as chairman of the Natural Gas Supply Association. NGSA is a trade association which represents the interests of independent and integrated companies which market roughly 90 percent of domestic gas production. NGSA is pleased to take this opportunity to participate in these timely proceedings on the FERC Order No. 436.

My remarks this morning, Mr. Chairman, will concentrate on matters pertinent to the pipeline transportation system established by FERC Order No. 436 and the revised block billing proposal which has been reissued in the form of a new notice of proposed rulemaking.

Mr. Chairman, I will summarize my comments, but would like to ask that the NGSA's more detailed comments be made a part of the record of these proceedings.

Senator NICKLES. Certainly.

Mr. HENTSCHEL. NGSA strongly supports those portions of Order 436 which will increase access to markets by encouraging pipelines to provide nondiscriminatory transportation services to third-party shippers. Basic economics suggest that increasing competition in the pipeline sector should lower consumer costs, since many of the problems associated with rising unit costs have occurred because of the tremendous loss in sales of gas.

We believe that all consumers should have real opportunities to buy gas from more than a single source, to the extent their contracts allow.

We were pleased that the Commission separated from the final order the radical and highly controversial proposal known as block billing. Mr. Chairman, your leadership in promoting legislation which would have directed FERC to delay implementation of the block billing scheme pending further consideration is very much appreciated by the NGSA members.

In its revised form, the Commission's block billing proposal would still reserve the rights of the so-called old gas with its regulated price to a select and arbitrary group of consumers. This would have the adverse consequence that the entire market would suffer. Block billing is a concept seriously flawed and one which offers consumers the false premise of a better deal.

We would note that the FERC's supplemental notice sets out a four-part test to determine whether a rate or practice is just and reasonable under section 5 of the NGPA. To satisfy the test, a rate or practice must first promote efficiency in both production and consumption; second, permit fair competition; third, avoid the wasteful depletion of natural gas; and fourth, accommodate the changing conditions of the industry.

We firmly believe that block billing fails each of these tests. Far from achieving the Commission's announced goal of a fair and efficient competitive market, block billing would make even worse an already bleak supply outlook, create a system of price distortions and discrimination among consumers, and fail to level the playing field of competition among pipelines.

Because block billing will reduce wellhead prices, the level of capital available to producers to fund the exploration and development of gas supplies will drop substantially. We asked Foster Associates to estimate the potential loss of revenue and supply due to block billing. They estimated that loss at between $5.3 billion and $18.7 billion over the years 1986 through 1990.

The subsequent reduced levels of drilling could cost future reserve additions during those years to be 1.8 to 5.8 trillion cubic feet lower than they would have otherwise been. With proven reserves of natural gas at their lowest level since 1976, the year of curtailments and shortages, it is remarkable that FERC is considering a proposal which might exacerbate the current slump in drilling activity when we are not replacing the reserves we consume each year.

In the fact of such disturbing statistics, the FERC argues that customers somehow will benefit. However, FERC cannot assure that any customers will benefit, nor can it point to which customers, if any, will see such benefit.

NGSA believes that the only real solution to the problems the Commission has identified is the unqualified and total decontrol of natural gas at the wellhead. Decontrol would not only achieve the Commission's goal of facilitating efficient and fair competition, but also would provide significant benefits to the consuming public in the form of enhanced security of supply at the least cost.

While concededly the Commission lacks the legal authority to decontrol, the Commission can—and we have recommended that it should—combine its authority under the Natural Gas Policy Act to apply diligently the standards of just and reasonableness to raise the ceiling prices on below-market regulated gas.

We also recommend that abandonment be pregranted where parties to a certificated sale cannot agree upon a renegotiated price within the prescribed ceiling.

On a related matter to increasing the competition in gas markets, there has been a common misconception that transmission costs are too small to have a material impact on end-user prices. In this regard, NGSA commissioned an analysis of financial data for major interstate pipelines. I have attached to my formal comments the executive summary and five diagrams which illustrate the results of that study.

The study corrects the misconception that costs, including those incurred through take-or-pay provisions, can only be addressed by changes in wellhead prices. The large increase in pipeline margins identified in the study confirms what economic theory would predict will happen when one cost component—in this case the wellhead prices—of a product is held at artificially low price several levels from the ultimate consumer. While end-user prices are subject to competitive market forces, the downstream costs will simply inflate to fill the cost vacuum created.

The conclusion seems evident: FERC is focusing on bringing more pressure to bear on wellhead prices, when in fact it should be focusing on assuring competitive transportation arrangements for deregulated supplies. If more consumers are permitted increased access and all gas were free to be priced by the market, the proper signals would be transmitted among the wellhead, the transporter, the local distribution company, and the consumer.

In closing, Mr. Chairman, I would note that Congress has asserted in the past its concern that domestic supplies of natural gas be continually developed and maintained at a rate adequate to keep pace with demand. With the reissuance of the block billing proposal in the new NOPR, FERC continues to focus incorrectly on short-term consumer prices for natural gas at the expense of adequate future domestic gas supplies.

Thank you for this opportunity to appear and present the views of the Natural Gas Supply Association.

[The prepared statement of Mr. Hentschel follows:]

TESTIMONY OF
DAVID A. HENTSCHEL
FOR THE
NATURAL GAS SUPPLY ASSOCIATION
(N-G-S-A)

GOOD MORNING, MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE. MY NAME IS DAVID HENTSCHEL. I AM THE CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF CITIES SERVICE OIL AND GAS CORPORATION, BASED IN TULSA, OKLAHOMA.

I AM APPEARING BEFORE YOU TODAY AS CHAIRMAN OF THE NATURAL GAS SUPPLY ASSOCIATION (N-G-S-A). N-G-S-A IS A TRADE ASSOCIATION WHICH REPRESENTS THE INTERESTS OF INDEPENDENT AND INTEGRATED NATURAL GAS PRODUCTION COMPANIES WHICH MARKET ROUGHLY 90 PERCENT OF DOMESTIC NATURAL GAS PRODUCTION. N-G-S-A IS PLEASED TO TAKE THIS OPPORTUNITY TO PARTICIPATE IN THESE TIMELY PROCEEDINGS ON THE FEDERAL ENERGY REGULATORY COMMISSION'S (F-E-R-C) ORDER 436.

MY REMARKS THIS MORNING, MR. CHAIRMAN, WILL CONCENTRATE ON MATTERS PERTINENT TO THE PIPELINE TRANSPORTATION SYSTEM ESTABLISHED BY THE F-E-R-C IN ORDER 436 ISSUED ON OCTOBER 9TH AND THE REVISED BLOCK BILLING PROPOSAL WHICH HAS BEEN RE-ISSUED IN THE FORM OF A NEW NOTICE OF PROPOSED RULEMAKING.

MR. CHAIRMAN, I WILL SUMMARIZE MY COMMENTS BUT WOULD LIKE TO COMMEND TO YOUR ATTENTION AND THAT OF THE MEMBERS OF THE SUBCOMMITTEE, N-G-S-A'S MORE DETAILED SUPPLEMENTAL COMMENTS FILED AT THE F-E-R-C ON NOVEMBER 18, 1985 CONCERNING PART D OF THE N-O-P-R. THESE COMMENTS ARE ATTACHED TO MY FORMAL REMARKS AS APPENDIX A AND I REQUEST THAT THEY BE MADE A PART OF THE RECORD OF THESE PROCEEDINGS.

DURING THE PERIOD FOLLOWING THE ISSUANCE OF THE NOTICE OF PROPOSED RULEMAKING (N-O-P-R) LATE IN MAY, CONSIDERABLE ATTENTION WAS FOCUSED ON THE MANY DIVERSE ASPECTS OF THE F-E-R-C'S PROPOSAL. AT THE COMMISSION'S PUBLIC HEARINGS ON THE N-O-P-R IN AUGUST, SUBSTANTIAL SUPPORT WAS EXPRESSED FOR PART A OF THE N-O-P-R WHICH PROVIDES NEW OPPORTUNITIES FOR NONDISCRIMINATORY ACCESS TO TRANSPORTATION.

N-G-S-A STRONGLY SUPPORTS THOSE PORTIONS OF ORDER 436 WHICH WILL INCREASE ACCESS TO MARKETS BY ENCOURAGING PIPELINES TO PROVIDE NONDISCRIMINATORY TRANSPORTATION SERVICES TO THIRD PARTY SHIPPERS. BASIC ECONOMICS SUGGEST THAT INCREASING COMPETITION IN THE PIPELINE SECTOR SHOULD LOWER CONSUMER COSTS SINCE MANY OF THE PROBLEMS ASSOCIATED WITH RISING UNIT COSTS

HAVE OCCURRED BECAUSE OF THE TREMENDOUS LOSS IN SALES OF GAS. WE BELIEVE THAT ALL CONSUMERS SHOULD HAVE REAL OPPORTUNITIES TO BUY GAS FROM MORE THAN A SINGLE SOURCE.

WE DO NOT SUPPORT, HOWEVER, THE PORTION OF THE TRANSPORTATION RULE WHICH PERMITS PURCHASERS TO ABROGATE THEIR EXISTING VALID CONTRACTS. THE PROVISION FOR A 25 PERCENT PER YEAR REDUCTION IN FIRM CONTRACT DEMAND WITH AN OPTION TO CONVERT TO A FIRM TRANSPORTATION OBLIGATION HAS BEEN CARRIED OVER FROM THE N-O-P-R. WE STILL BELIEVE THAT A PRIVATE CONTRACT BETWEEN TWO PARTIES OUGHT TO BE HONORED UNTIL THOSE PARTIES DECIDE TO CHANGE OR END IT. GOVERNMENT INTERFERENCE IN PRIVATE CONTRACTS SUCH AS THAT PROPOSED BY F-E-R-C IN ORDER 436 IS NEITHER NECESSARY, NOR FAIR, JUST AS GOVERNMENT REQUIREMENTS TO CONTINUE TO PROVIDE SERVICE UNDER THE TERMS OF WELLHEAD CONTRACTS WHICH HAVE EXPIRED INTERFERE IN THE EFFICIENT WORKINGS OF THE MARKET.

CONSISTENT WITH THE SUGGESTIONS OF YOURSELF, MR. CHAIRMAN, A NUMBER OF YOUR COLLEAGUES, N-G-S-A, AND MANY OTHER PARTICIPANTS IN THE N-O-P-R PROCESS, THE COMMISSION SEPARATED FROM THE FINAL ORDER A RADICAL AND HIGHLY CONTROVERSIAL

PROPOSAL KNOWN AS "BLOCK BILLING." MR. CHAIRMAN, YOU ARE WELL AWARE OF THE MANY CONCERNS RAISED BY PRODUCERS IN RESPONSE TO THE ORIGINAL BLOCK BILLING PROPOSAL. YOUR LEADERSHIP IN PROMOTING LEGISLATION WHICH WOULD HAVE DIRECTED F-E-R-C TO DELAY IMPLEMENTATION OF THE BLOCK BILLING SCHEME PENDING FURTHER CONSIDERATION BY THE F-E-R-C IS VERY MUCH APPRECIATED BY N-G-S-A'S MEMBERS.

DURING THE PROCEEDINGS HELD ON SEPTEMBER 19, 1985, N-G-S-A'S VICE-CHAIRMAN, DANNY CONKLIN, POINTED OUT TO THE SUBCOMMITTEE THAT F-E-R-C'S BLOCK BILLING PROPOSAL WOULD MERELY PUSH EXISTING PRICING DISTORTIONS FURTHER DOWN THE MARKETING CHAIN, RESULTING IN A NEW SYSTEM OF PRICE DISTORTIONS AND DISCRIMINATION WITH A DIFFERENT ALLOCATION OF ECONOMIC RENTS. F-E-R-C PROPOSES TO DRASTICALLY ALTER NATURAL GAS PRICING WITHOUT ANY APPARENT SOCIAL JUSTIFICATION. F-E-R-C MUST BEAR IN MIND THAT ITS GOAL IS TO SERVE THE PUBLIC INTEREST.

EVEN IN ITS REVISED FORM, THE COMMISSION'S BLOCK BILLING PROPOSAL WOULD RESERVE THE RIGHTS OF SO-CALLED "OLD" GAS WITH ITS REGULATED PRICES TO A SELECT AND ARBITRARY GROUP OF

CONSUMERS WITH THE ADVERSE CONSEQUENCE THAT THE ENTIRE MARKET WILL SUFFER. BLOCK BILLING IS A CONCEPT SERIOUSLY FLAWED AND ONE WHICH OFFERS CONSUMERS THE FALSE PROMISE OF A BETTER DEAL.

MR. CHAIRMAN, AS YOU ARE AWARE, F-E-R-C'S SUPPLEMENTAL NOTICE CONCERNING BLOCK BILLING CITES SECTION 5 OF THE NATURAL GAS ACT TO SUPPORT THE COMMISSION'S AUTHORITY TO IMPLEMENT BLOCK BILLING. SECTION 5 PROVIDES THAT, ONCE THE COMMISSION FINDS A RATE OR PRACTICE TO BE "UNJUST (OR) UNREASONABLE," IT "SHALL DETERMINE THE JUST AND REASONABLE" RATE OR PRACTICE TO BE ENFORCED. (15 U.S.C. .717D (1976)).

WE WOULD NOTE THAT THE F-E-R-C'S SUPPLEMENTAL NOTICE SETS OUT A FOUR PART TEST TO DETERMINE WHETHER A RATE OR PRACTICE IS JUST AND REASONABLE UNDER SECTION 5. TO SATISFY THE TEST, A RATE OR PRACTICE MUST (A) PROMOTE "EFFICIENCY IN BOTH PRODUCTION AND CONSUMPTION," (B) "PERMIT 'FAIR' COMPETITION," (C) AVOID "THE WASTEFUL DEPLETION OF NATURAL GAS," AND (D) ACCOMODATE "TO CHANGING CONDITIONS" IN THE INDUSTRY.

WE FIRMLY BELIEVE THAT BLOCK BILLING FAILS EACH OF THESE TESTS. FAR FROM ACHIEVING THE COMMISSION'S ANNOUNCED GOAL OF A FAIR AND EFFICIENT COMPETITIVE MARKET IN WHICH BELOW-MARKET

GAS HAS BEEN ELIMINATED FROM THE MARGINAL DECISIONS OF CONSUMERS AND PRODUCERS. BLOCK BILLING WOULD (1) MAKE EVEN WORSE AN ALREADY BLEAK SUPPLY OUTLOOK, (2) CREATE A SYSTEM OF PRICE DISTORTIONS AND DISCRIMINATION AMONG CONSUMERS, AND (3) FAIL TO LEVEL THE PLAYING FIELD OF COMPETITION AMONG PIPELINES.

N-G-S-A REMAINS FIRM IN ITS BELIEF THAT BLOCK BILLING WOULD SIGNIFICANTLY HARM EXPLORATION AND DEVELOPMENT OF NEW GAS SUPPLIES. F-E-R-C APPARENTLY IS STILL UNCERTAIN AS TO THE SUPPLY IMPACT OF BLOCK BILLING. ADDITIONAL TESTIMONY AND EVIDENCE HAS BEEN REQUESTED IN THE REVISED NOTICE, AND N-G-S-A HAS CONDUCTED CONSIDERABLE ADDITIONAL RESEARCH IN THIS REGARD. THERE IS NO QUESTION BUT THAT BLOCK BILLING WOULD RETAIN BELOW MARKET PRICES FOR A SUBSTANTIAL PORTION OF THE NATION'S PROVED NATURAL GAS RESERVES AND WOULD MAINTAIN PRICES FOR THESE SUPPLIES BELOW THE COSTS OF REPLACING THE GAS.

WHILE IT IS DIFFICULT TO FOCUS ON FUTURE SUPPLIES DURING A PERIOD WHEN THERE IS A DELIVERABILITY SURPLUS, THE ENERGY INFORMATION ADMINISTRATION (E-I-A) ESTIMATES OF 1984 PRELIMINARY NATURAL GAS RESERVES, DISCUSSED BY N-G-S-A IN

ITS SEPTEMBER 19TH TESTIMONY BEFORE THIS SUBCOMMITTEE, DEMONSTRATE THE CONTINUATION OF AN ALARMING TREND WHICH WILL CERTAINLY BE EXACERBATED BY F-E-R-C'S BLOCK BILLING PROPOSAL. E-I-A FIGURES INDICATE THAT NATURAL GAS PRODUCTION ONCE AGAIN OUTPACED THE LEVEL OF NEW GAS DISCOVERIES IN 1984. NEW GAS DISCOVERIES IN 1984 AMOUNTED TO ONLY 79 PERCENT OF THE LEVEL OF NATURAL GAS PRODUCTION.

THE POINT TO EMPHASIZE IS THAT SUBSTANTIAL CORRECTIONS ARE ALREADY OCCURRING AT THE SUPPLY END TO BRING SHORT-TERM SUPPLY AND DEMAND IN BALANCE UNDER CURRENT POLICIES. THE BLOCK BILLING PROPOSAL WILL NOT SMOOTH THIS TRANSITION NOR WILL IT ELIMINATE THE DISTORTIONS AND INEQUITIES WHICH MAKE THE TRANSITION PAINFUL. BLOCK BILLING WILL HAVE SEVERE CONSEQUENCES FOR LONG-TERM SUPPLY AND DEMAND BALANCE

BECAUSE BLOCK BILLING WILL REDUCE PRICES FOR GAS SUPPLIES, THE LEVEL OF CAPITAL AVAILABLE TO PRODUCERS TO FUND THE EXPLORATION AND DEVELOPMENT OF GAS SUPPLIES WILL DROP SUBSTANTIALLY. FOSTER ASSOCIATES, INC. HAS ESTIMATED THE POTENTIAL LOSS OF REVENUE DUE TO BLOCK BILLING AT BETWEEN $5.3 BILLION AND $18.7 BILLION OVER THE YEARS 1986 THRU 1990 (SEE

APPENDIX A OF THE N-G-S-A SUPPLEMENTAL COMMENTS). THE SUBSEQUENT REDUCED LEVELS OF DRILLING COULD CAUSE FUTURE RESERVE ADDITIONS DURING THOSE YEARS TO BE 1.8 TO 5.8 TCF LOWER THAN THEY OTHERWISE WOULD HAVE BEEN. WITH PROVEN RESERVES OF NATURAL GAS AT THEIR LOWEST LEVEL SINCE 1976 -- THE YEAR OF CURTAILMENTS AND SHORTAGES -- IT IS REMARKABLE THAT F-E-R-C IS CONSIDERING A PROPOSAL WHICH MIGHT EXACERBATE THE CURRENT SLUMP IN DRILLING ACTIVITY.

THE STATISTICS CONCERNING LEVELS OF DRILLING ACTIVITY ARE ALARMING. DURING THE PEAK YEAR IN 1982, THE PRODUCING INDUSTRY SPENT $18.7 BILLION TO DRILL 24,695 GAS WELLS. THESE WELLS REPLACED 83 PERCENT OF THAT YEAR'S PRODUCTION WITH NEW DISCOVERIES -- STILL A NET LOSS IN RESERVE LEVELS. DRILLING EXPENDITURES IN 1984, HOWEVER, DROPPED PRECIPITOUSLY TO $11.7 BILLION -- A 37 PERCENT DECREASE. THE CONSEQUENCE OF THIS REDUCTION IN DRILLING EXPENDITURES CAUSED THE NUMBER OF WELLS DRILLED TO DECREASE BY 36 PERCENT TO 15,705.

IN 1981, WHICH WAS A VERY GOOD YEAR FOR THE DRILLING BUSINESS, THE ROTARY RIG COUNT AVERAGED 3,970. BY NOVEMBER 18TH OF THIS YEAR, THE RIG COUNT STOOD AT 1,942 -- A 51

PERCENT REDUCTION SINCE 1981 IN THE NUMBER OF RIGS WORKING IN THIS COUNTRY. THE NUMBER OF ACTIVE RIGS IN THE UNITED STATES TODAY IS 28 PERCENT LOWER THAN IT WAS IN NOVEMBER, 1978, WHEN THE NATURAL GAS POLICY ACT WAS PASSED WITH THE PURPOSE OF ENCOURAGING A SUBSTANTIAL INCREASE IN THE LEVEL OF DOMESTIC ENERGY EXPLORATION ACTIVITIES.

IF BLOCK BILLING IS IMPLEMENTED, THE RANGE OF THE RESULTING BLOCK 2 PRICES COULD YIELD SUBSTANTIALLY FEWER GAS WELLS DRILLED PER YEAR. THE IMPACT ON EMPLOYMENT WOULD BE STAGGERING. FROM A HIGH IN 1982 WHEN EMPLOYMENT STOOD AT 600,000 JOBS IN DRILLING INDUSTRIES, EMPLOYMENT NOW STANDS AT LESS THAN 250,000 -- A LOSS OF 350,000 JOBS. IMPLEMENTATION OF BLOCK BILLING UNDOUBTEDLY WOULD CAUSE A LARGE NUMBER OF THE REMAINING JOBS TO BE ELIMINATED WITH A STRONG RIPPLE EFFECT UPON ASSOCIATED BUSINESSES.

IN THE FACE OF THESE DISTURBING STATISTICS, F-E-R-C ARGUES THAT CUSTOMERS WILL SOMEHOW BENEFIT. HOWEVER, F-E-R-C CANNOT ASSURE THAT ANY CUSTOMERS WILL BENEFIT, NOR CAN IT POINT TO WHICH CUSTOMERS, IF ANY, WILL SEE SUCH BENEFITS. IN ORDER TO ASSURE THAT LOCAL CORE MARKET RESIDENTIAL AND SMALL

BUSINESS CONSUMERS ACTUALLY SEE ANY BENEFITS WHICH MAY FLOW FROM F-E-R-C'S BLOCK BILLING PROPOSAL, F-E-R-C WOULD BE REQUIRED TO INVADE THE PROVINCE OF THE STATE PUBLIC UTILITY COMMISSIONS. OF COURSE, F-E-R-C HAS NO JURISDICTION TO DO SO. THE CONSEQUENCE WILL BE THAT IDENTICAL CONSUMERS IN DIFFERENT REGIONS OF THE COUNTRY MAY SEE ADDITIONAL DIFFERENCES IN THE PRICES THEY PAY FOR NATURAL GAS UNDER F-E-R-C'S BLOCK BILLING PROPOSAL.

IF ROLLED-IN PRICING IS DISPOSED OF IN PREFERENCE FOR F-E-R-C'S BLOCK BILLING PLAN, INDUSTRIAL CONSUMERS MAY BE AFFECTED MOST SEVERELY. THIS IS SO BECAUSE STATE PUBLIC UTILITY COMMISSIONS WHEN FACED WITH THE CHOICE OF ALLOCATING THE LIMITED OLD GAS SUBSIDIES AMONG MANY CONSUMERS MAY DECIDE THAT RESIDENTIAL CONSUMERS SHOULD RECEIVE THE OLD GAS PRICES TO THE EXTENT POSSIBLE. THE PRICE DISCRIMINATION WHICH RESULTS WILL BE DRAMATIC FOR INDUSTRIAL CONSUMERS WHO MAY BE FORCED TO PURCHASE A HIGHER PROPORTION OF, OR EXCLUSIVELY, HIGHER COST NEW GAS. THE COSTS TO SUCH INDUSTRIAL CONSUMERS MAY PROVE TOO GREAT AND COMPEL PLANT MANAGERS TO REDUCE EMPLOYMENT LEVELS, OR EVEN TO CLOSE THEIR PLANTS.

FOR THESE REASONS, F-E-R-C'S BLOCK BILLING PROPOSAL DOES NOT SATISFY THE COMMISSION'S OWN CRITERIA FOR A JUST AND REASONABLE RATE OR PRACTICE UNDER THE NATURAL GAS ACT (N-G-A). THE PROPOSAL, THEREFORE, CONSTITUTES UNWISE PUBLIC POLICY.

IN ITS SUPPLEMENTAL NOTICE REQUESTING ADDITIONAL COMMENTS ON THE BLOCK BILLING PLAN, THE COMISSION DESCRIBES WHAT IT PERCEIVES TO BE SERIOUS MARKET PROBLEMS AND DISTORTIONS INHIBITING COMPETITION IN THE INDUSTRY. N-G-S-A BELIEVES THAT THE ONLY REAL SOLUTION TO THE PROBLEMS THE COMMISSION HAS IDENTIFED IS THE UNQUALIFIED AND TOTAL DECONTROL OF NATURAL GAS AT THE WELLHEAD. DECONTROL WOULD NOT ONLY ACHIEVE THE COMMISSION'S GOAL OF FACILITATING EFFICIENT AND FAIR COMPETITION, BUT ALSO WOULD PROVIDE SIGNIFICANT BENEFITS TO THE CONSUMING PUBLIC IN THE FORM OF ENHANCED SECURITY OF SUPPLY AT THE LEAST COST.

GIVEN RECENT EXPERIENCE WITH THE EFFECTS OF OIL DECONTROL IN 1981, AND PARTIAL DECONTROL OF NATURAL GAS UNDER THE N-G-P-A ON JANUARY 1ST OF THIS YEAR, NO "FLY-UP" OF PRICES WOULD RESULT FROM IMMEDIATE COMPREHENSIVE DECONTROL OF NATURAL GAS

PRICES AT THE WELLHEAD. WHEN THE BENEFITS OF DECONTROL ARE COMPARED WITH THE ADVERSE EFFECTS OF BLOCK BILLING, IT IS CLEAR THAT DECONTROL IS THE PRO-CONSUMER POLICY AND BLOCK BILLING IS, IN FACT, AN ANTI-CONSUMER POLICY. THE CONSUMER BENEFITS REALIZED FROM TOTAL DECONTROL OF OIL AND PARTIAL DECONTROL OF NATURAL GAS LEAVE LITTLE CREDIBILITY TO THE ARGUMENT OF THOSE WHO CLAIM THAT CONTINUED GOVERNMENT INTERVENTION AT THE NATURAL GAS WELLHEAD IS REQUIRED.

CONCEDEDLY, HOWEVER, THE COMMISSION LACKS THE LEGAL AUTHORITY TO "LEGISLATE" DECONTROL. BUT THERE ARE STEPS THAT THE COMMISSION CAN TAKE TO MITIGATE THE EFFECTS OF BELOW-MARKET WELLHEAD PRICE REGULATION DURING THE PERIOD OF TRANSITION TO A MORE FULLY COMPETITIVE INDUSTRY. N-G-S-A BELIEVES THAT F-E-R-C COULD FACILITATE THIS PROCESS BY: (1) ALLOWING ALL CONSUMERS ACCESS TO A GREATER AMOUNT OF LEAST COST SUPPLIES, RATHER THAN JUST THOSE CONSUMERS WITH THE HISTORICAL ADVANTAGE AS F-E-R-C NOW PROPOSES; AND (2) INCREASING INCENTIVES FOR PARTIES TO NEGOTIATE AWAY ARTIFICIAL VARIATIONS IN PURCHASED GAS COSTS RESULTING FROM THE PERSISTENCE OF BELOW-MARKET PRICE REGULATED NATURAL GAS.

TO THESE ENDS, THE COMMISSION CAN COMBINE ITS AUTHORITY, UNDER THE NATURAL GAS POLICY ACT OF 1978 (N-G-P-A), TO APPLY DILIGENTLY THE STANDARDS OF JUST AND REASONABLENESS TO RAISE THE CEILING PRICES ON BELOW-MARKET REGULATED GAS, WITH PRE-GRANTED ABANDONMENT WHERE PARTIES TO A CERTIFICATED SALE CANNOT AGREE UPON A RENEGOTIATED PRICE WITHIN THE PRESCRIBED CEILING.

N-G-S-A HAS IDENTIFIED TO THE F-E-R-C ALTERNATIVE PROGRAMS WHICH THE COMMISSION MIGHT ADOPT TO ADJUST PRICE CEILINGS TO JUST AND REASONABLE LEVELS.

N-G-S-A BELIEVES THAT THE F-E-R-C, BY EXERCISING ITS AUTHORITY TO ADJUST OLD GAS PRICE CEILINGS, COULD ATTACK THE PROBLEM OF BELOW-MARKET PRICE REGULATION HEAD ON, RATHER THAN MERELY SEEKING TO PUSH THE PROBLEM INDUCED BY A HISTORICALLY SKEWED SET OF FEDERAL REGULATIONS DOWN TO THE STATE LEVEL.

RATHER THAN ESTABLISHING A SYSTEM OF GOVERNMENT ENTITLEMENTS TO OLD GAS SUPPLIES AS F-E-R-C PROPOSES IN ITS BLOCK BILLING PROPOSAL -- THEREBY HEIGHTENING ARBITRARY PRICE DIFFERENCES AMONG IDENTICAL CONSUMERS AS DETAILED IN N-G-S-A'S SEPTEMBER 19TH TESTIMONY BEFORE THE SUBCOMMITTEE -- THE

COMMISSION SHOULD DROP THE BLOCK BILLING PROPOSAL AND CONCENTRATE ON WAYS OF GETTING GAS TO WILLING BUYERS. THE COMMISSION SHOULD STRIVE TO ALLOW ADDITIONAL CONSUMERS INCREASED ACCESS TO HIGHLY COMPETITIVE NATURAL GAS SUPPLIES.

WHILE THE WEIGHTED AVERAGE COST OF GAS FOR MAJOR INTERSTATE PIPELINES HAS STEADILY DECLINED, AVERAGE NATIONWIDE RESIDENTIAL PRICES FOR THE FIRST SIX MONTHS OF 1985 WERE 12¢ HIGHER THEN FOR THE FIRST SIX MONTHS OF 1984.

THIS FACT OF FLAT OR DECLINING WELLHEAD PRICES WHICH DO NOT NECESSARILY RESULT IN LOWER BURNER TIP PRICES HAS BEEN OF INCREASING INTEREST TO N-G-S-A. THIS IS ESPECIALLY SO IN LIGHT OF REPRESENTATIONS MADE LAST WEEK DURING PROCEEDINGS BEFORE THE HOUSE SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS BY SEVERAL PIPELINES.

DURING THOSE HEARINGS, THE INDIVIDUAL PIPELINE COMPANIES APPEARING AND THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA (I-N-G-A-A), WERE GENERALLY UNIFIED IN THEIR REPRESENTATION THAT F-E-R-C SHOULD IMPOSE A CONDITION UPON ACCESS TO NONDISCRIMINATORY TRANSPORTATION CONSISTING OF "MANDATED" RENEGOTIATION -- OR COMPLETE FORGIVENESS -- OF

PIPELINES' TAKE-OR-PAY OBLIGATIONS. THE PIPELINES ALSO ARGUE THAT CONGRESSIONAL INTERVENTION TO PROVIDE SUCH RELIEF IS VIRTUALLY THE ONLY SOLUTION, DESPITE THE EVIDENCE AT THE HOUSE HEARING THAT MOST PIPELINES HAVE NOT EXPERIENCED ANY SUBSTANTIAL DIFFICULTY IN RESOLVING ANY TAKE-OR-PAY PROBLEMS THEY MAY HAVE EXPERIENCED.

MOREOVER, A COMMON MISCONCEPTION REGARDING GAS COSTS IS THAT THE ONLY SOURCE FOR MEANINGFUL CHANGE IN CONSUMER PRICES IS AT THE WELLHEAD SINCE TRANSMISSION COSTS ARE TOO SMALL TO HAVE A MATERIAL IMPACT ON END-USER PRICES. IN THIS REGARD, N-G-S-A COMMISSIONED AN ANALYSIS OF FINANICAL DATA FOR MAJOR INTERSTATE PIPELINES. THE ANALYSIS WAS BASED UPON INFORMATION SUPPLIED TO F-E-R-C BY PIPELINES IN A DOCUMENT REFERRED TO AS THE "F-E-R-C FORM 2." IN FORM 2, AUDITED BY RECOGNIZED PUBLIC ACCOUNTING FIRMS, THE PIPELINES PROVIDE COMPLETE FINANCIAL DATA ON THEIR GAS UTILITY OPERATIONS.

THE PURPOSE OF THIS STUDY -- WHICH WE RELEASED ON NOVEMBER 12 -- WAS TO OBTAIN AN ACCURATE PORTRAYAL OF THE ACTUAL FINANCIAL PERFORMANCE OF 25 MAJOR INTERSTATE PIPELINES OVER THE PERIOD 1977-1984. THE EXECUTIVE SUMMARY OF THE

REPORT IS ATTACHED AS APPENDIX B, AND I ASK THAT IT BE MADE A PART OF THE RECORD OF THESE PROCEEDINGS.

AS ILLUSTRATED IN DIAGRAM #1, OUR STUDY REVEALS THAT OVER THE LAST FIVE YEARS NATURAL GAS PIPELINES AS REGULATED UTILITIES HAVE ENJOYED UNUSUALLY HIGH RATES OF RETURN ON TOTAL CAPITAL AND COMMON EQUITY. THE REPORT DEMONSTRATES THAT WHEN CONTRASTED WITH AN AVERAGE FOR 900 LARGE COMPANIES BASED UPON DATA SUPPLIED BY VALUE LINE, PIPELINES HAVE ACHIEVED SIGNIFICANTLY HIGHER RETURNS THAN THE VALUE LINE 900 -- AND THE DIFFERENTIAL APPEARS TO HAVE INCREASED IN RECENT YEARS.

IT IS ALSO NOTEWORTHY THAT THE AVERAGE OF THE MAJOR PIPELINE RATES OF RETURN FOR AT LEAST THE PAST THREE YEARS HAS BEEN HIGHER THAN THE AVERAGE OF THE F-E-R-C AUTHORIZED RATES OF RETURN -- USUALLY BY A SUBSTANTIAL AMOUNT (SEE DIAGRAM #2).

THE N-G-S-A ANALYSIS ALSO REVIEWED PIPELINE MARGINS. IT WAS DISCOVERED THAT DUE TO THE PYRAMIDING OF TRANSPORTATION COSTS, THE UNIT COSTS THAT PIPELINES ACTUALLY ADD TO DELIVERED COSTS TO THE CONSUMERS OFTEN ARE HIGHER THAN REPORTED (SEE DIAGRAM #3).

THUS, THE STUDY CORRECTS THE MISCONCEPTION THAT COSTS INCLUDING THOSE INCURRED THROUGH TAKE-OR-PAY PROVISIONS CAN ONLY BE ADDRESSED BY CHANGES IN WELLHEAD PRICES. FOR EXAMPLE, IN 1984 PIPELINE COSTS ACCOUNTED FOR $1.64 PER MCF, OR ABOUT ONE-THIRD OF THE PRICE PAID BY GAS CONSUMERS (SEE DIAGRAM #4). OF THE $1.64 PIPELINE MARGIN, 55¢ IS PIPELINE GROSS EARNINGS. NOT ONLY ARE THE PIPELINES' "COSTS" VERY LARGE, BUT THEY HAVE GROWN ENORMOUSLY OVER THE PERIOD, MORE THAN 200 PERCENT OR DOUBLING SINCE 1977. IN CONTRAST, THE INFLATION OVER THE SAME PERIOD WAS ONLY 59 PERCENT.

THE LARGE INCREASE IN PIPELINE MARGINS CONFIRMS WHAT ECONOMIC THEORY WOULD PREDICT WILL HAPPEN WHEN ONE COST COMPONENT -- WELLHEAD GAS PRICES -- OF A PRODUCT IS HELD AT AN ARTFICIALLY LOW PRICE, SEVERAL LEVELS FROM THE ULTIMATE CONSUMER. WHILE END-USER PRICES ARE SUBJECT TO COMPETITIVE MARKET FORCES, THE DOWNSTREAM COSTS WILL SIMPLY INFLATE TO FILL THE COST VACUUM CREATED (SEE DIAGRAM #5).

IN THEORY, THE REGULATORY AGENCIES WHICH OVERSEE THESE ACTIVITIES SHOULD PREVENT THIS, BUT SINCE F-E-R-C REGULATION IS COST-BASED, THE FOCUS OF THE PIPELINE COMPANIES IS ON COST

JUSTIFICATION, NOT COST MINIMIZATION. UNCONSTRAINED BY COMPETITIVE MARKET FORCES AND WITH THE PIPELINES FOCUSING ON COST JUSTIFICATION, COSTS CAN BE EXPECTED TO RISE RAPIDLY, WHICH THE STUDY SHOWS INDEED DID HAPPEN.

FINALLY, OVER THE PERIOD 1977 TO 1984, PIPELINE SALES TO END-USERS DECLINED BY APPROXIMATELY 7 PERCENT. IN SUCH A PERIOD OF DECLINING VOLUME, IT WOULD GENERALLY BE EXPECTED THAT THERE WOULD BE LESS NEED FOR SUBSTANTIAL NEW PIPELINE CAPITAL INVESTMENTS. IT ALSO WOULD BE EXPECTED THAT PIPELINES' NET DEPRECIATED INVESTMENT WOULD SHRINK. HOWEVER, THE RESULT OF NOT MAKING NEW CAPITAL INVESTMENTS TO OFFSET DEPRECIATION IS A DECLINE IN THE RATE BASE WHICH WOULD CURTAIL PROFITS. THUS THERE IS IN THE REGULATIONS A POWERFUL INCENTIVE TO MAKE NEW INVESTMENTS SOLELY TO PREVENT THIS DECLINE FROM OCCURRING AND NOT BECAUSE THE LEVEL OF INVESTMENT IS THE MOST ECONOMICALLY EFFICIENT.

THE N-G-S-A STUDY DEMONSTRATES THAT THE PIPELINES' NET INVESTMENT DID NOT DECLINE DURING THIS PERIOD OF REDUCED SALES, BUT INSTEAD EXPANDED SUBSTANTIALLY. DURING THE 1977-1984 PERIOD, BECAUSE OF NEW INVESTMENTS OF APPROXIMATELY $14.3

BILLION, THE PIPELINES NOT ONLY OFF-SET $7.9 BILLION OF DEPRECIATION, BUT ACTUALLY INCREASED THEIR NET DEPRECIATED INVESTMENT FROM $11.3 BILLION IN 1977 TO $15.6 BILLION IN 1984. THIS HELPS EXPLAIN HOW THE NET OPERATING EARNINGS OVER THE 1977-1984 PERIOD COULD INCREASE BY 67 PERCENT WHILE SALES TO END-USERS DECLINED BY 7 PERCENT.

THE CONCLUSION SEEMS EVIDENT: F-E-R-C IS FOCUSING ON BRINGING MORE PRESSURE TO BEAR ON WELLHEAD PRICES WHEN IN FACT IT SHOULD BE FOCUSING ON ASSURING COMPETITIVE TRANSPORTATION ARRANGEMENTS. IF MORE CONSUMERS ARE PERMITTED INCREASED ACCESS TO MARKET-PRICED NATURAL GAS SUPPLIES, THE PROPER SIGNALS WOULD BE TRANSMITTED AMONG THE WELLHEAD, THE TRANSPORTER, THE LOCAL DISTRIBUTION COMPANY AND THE CONSUMER.

THE DEREGULATION OF OIL HAS RESULTED IN INCREASED SUPPLY AT GENERALLY STABLE OR DECLINING PRICES. THE SAME PRINCIPLES WHICH APPLY TO OIL APPLY TO NATURAL GAS.

IN CLOSING, MR. CHAIRMAN, I WOULD NOTE THAT N-G-S-A BELIEVES THAT THE F-E-R-C AND CONGRESS HAVE ASSERTED IN THE PAST THAT A PRIMARY CONCERN IS TO ASSURE THAT DOMESTIC

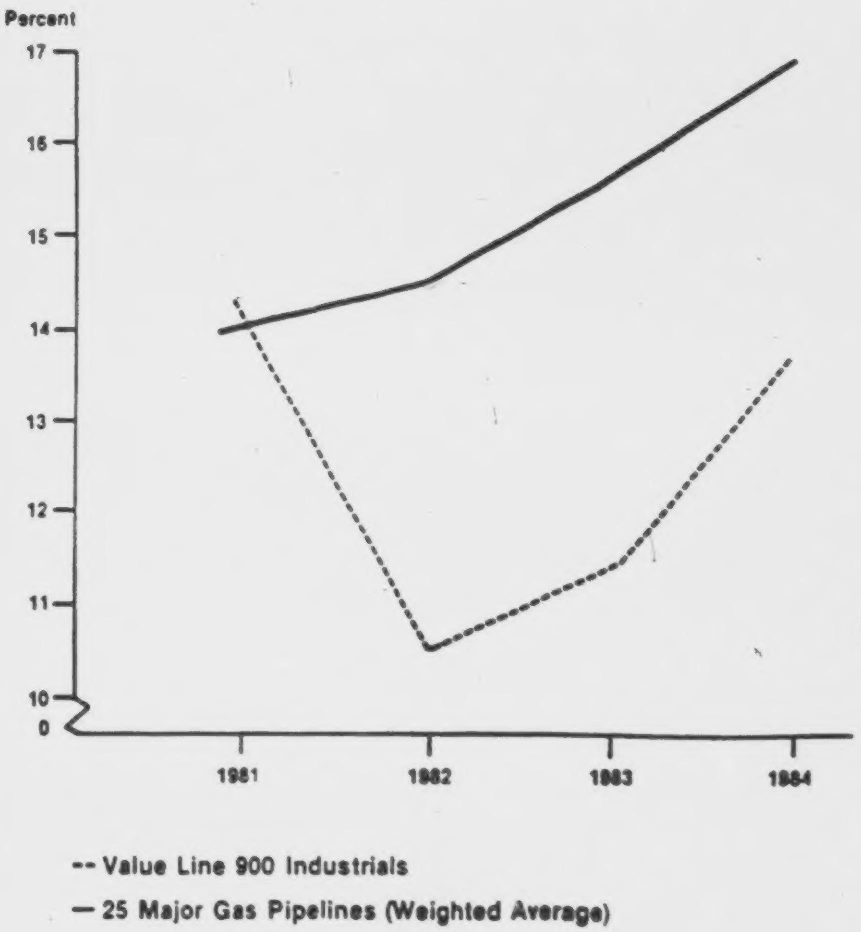
SUPPLIES OF NATURAL GAS ARE CONTINUALLY DEVELOPED AND MAINTAINED AT A RATE ADEQUATE TO KEEP PACE WITH DEMAND. WITH THE RE-ISSUANCE OF THE BLOCK BILLING PROPOSAL IN THE NEW N-O-P-R, F-E-R-C INCORRECTLY CONTINUES TO FOCUS ON SHORT-TERM CONSUMER PRICES FOR NATURAL GAS, AT THE EXPENSE OF ADEQUATE FUTURE DOMESTIC GAS SUPPLIES. THE NEW DISTORTIONS WHICH WILL RESULT FROM THE BLOCK BILLING SCHEME WILL SET UP A NEW ORDER OF PRICE DISCRIMINATION WHICH WE DON'T BELIEVE WAS ENVISIONED BY THE ARCHITECTS OF THE N-G-P-A.

N-G-S-A BELIEVES THAT THE DISTORTIONAL EFFECTS OF THE "CUSHION" OF OLD GAS SUPPLIES CAN ONLY BE REMOVED BY THE ELIMINATION OF WELLHEAD PRICE CONTROLS. DEREGULATION OF NATURAL GAS WOULD ENCOURAGE THE OPTIMUM LEVEL OF DEVELOPMENT OF LEAST COST GAS IN A COMPETITIVE ATMOSPHERE. CONSUMERS WOULD BE PROVIDED NATURAL GAS AT THE LOWEST REASONABLE RATES CONSISTENT WITH RELIABLE LONG-TERM SUPPLIES. SUCH ACTION WOULD ALSO ELIMINATE MARKET DISTORTIONS WHICH HAVE RESULTED FROM PRIOR REGULATORY POLICIES. LEGISLATION SUCH AS S. 1302 WHICH YOU AUTHORED MAY REPRESENT AN APPROPRIATE VEHICLE FOR ACCOMPLISHING MANY OF THESE OBJECTIVES.

THANK YOU FOR THIS OPPORTUNITY TO APPEAR AND PRESENT THE VIEWS OF THE NATURAL GAS SUPPLY ASSOCIATION. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS WHICH YOU MAY HAVE.

DIAGRAM #1

Return on Common Equity
25 Major Pipelines vs Industrials

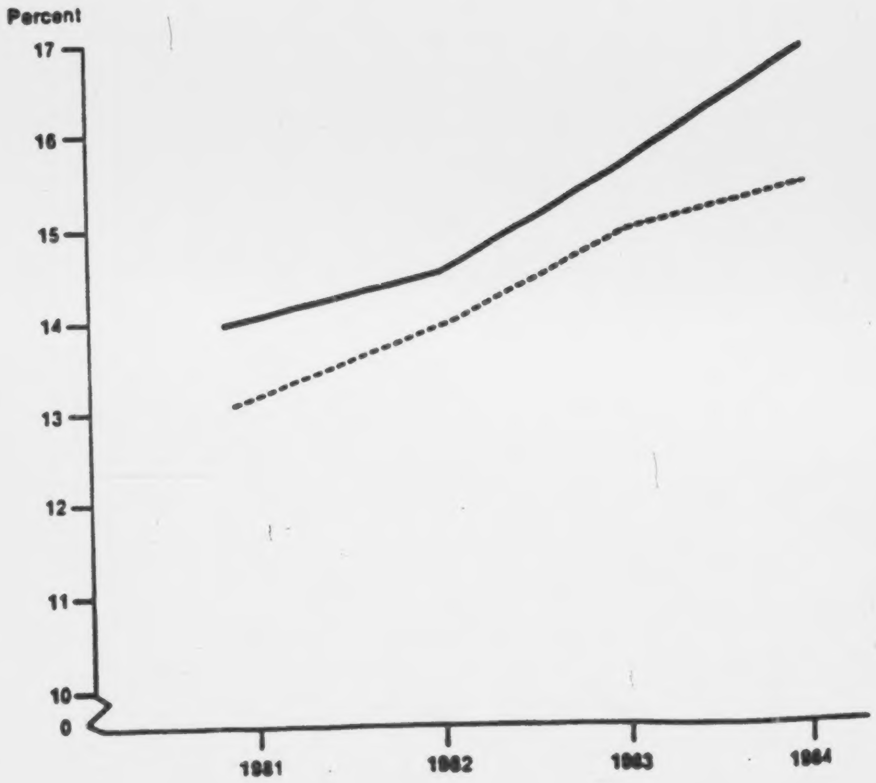


Source: Federal Energy Regulatory Commission

Natural Gas Supply Association

DIAGRAM #2

25 Major Pipelines Rate of Return
(Common Equity)
vs
FERC Authorized Rate of Return



—Actual Rate of Return (Average)

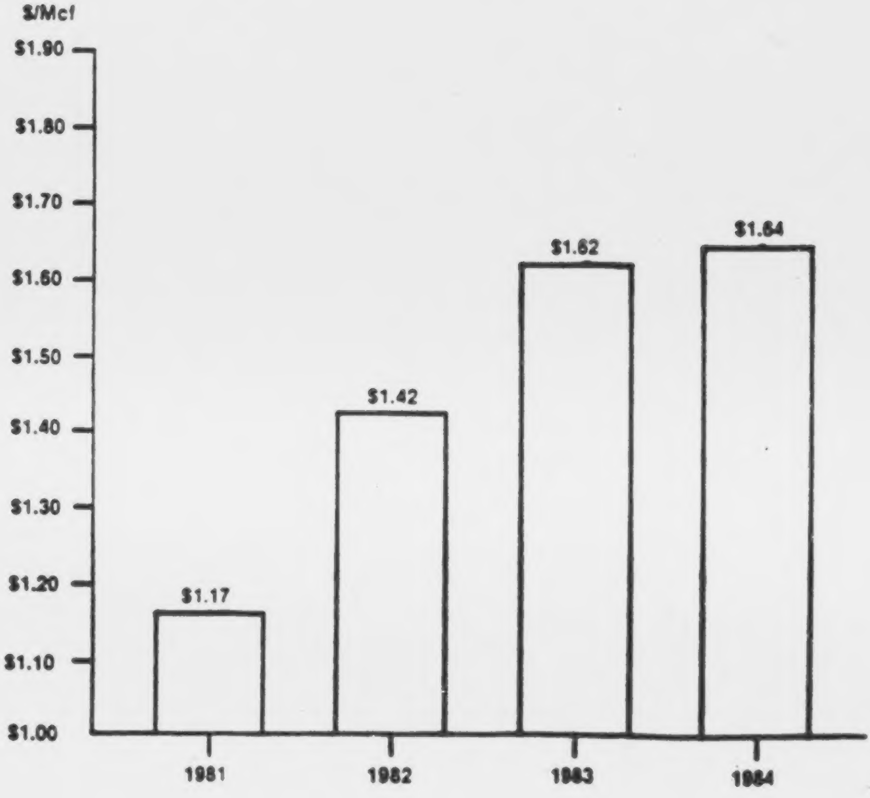
--FERC Authorized Rate of Return (Average)

Source: Federal Energy Regulatory Commission

Natural Gas Supply Association

DIAGRAM #3

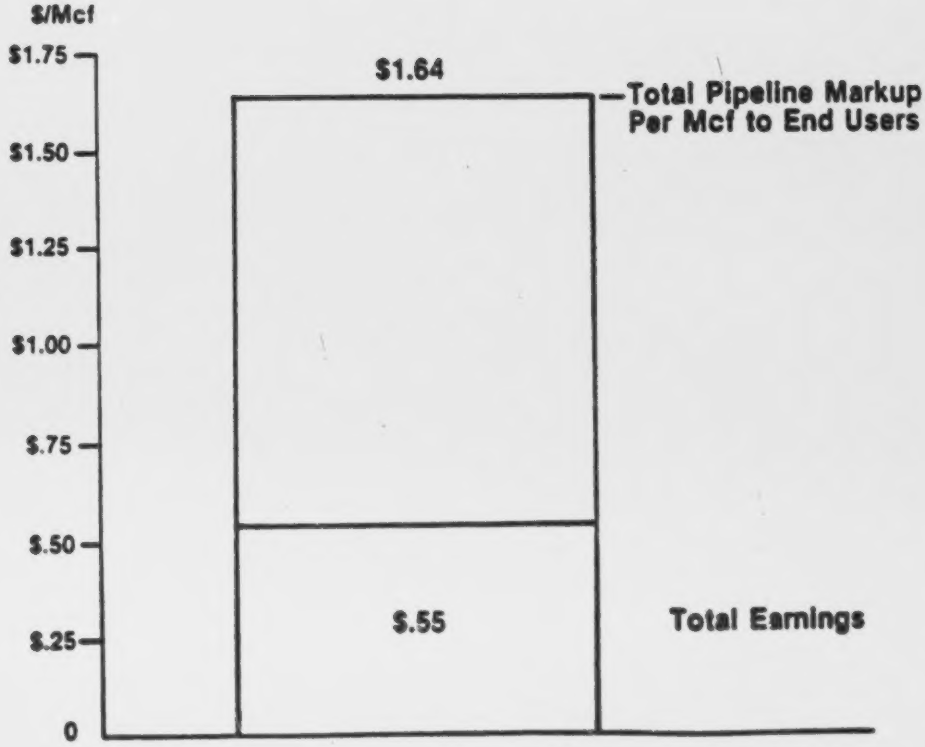
Total Pipeline Markup to End Users



Source: Federal Energy Regulatory Commission

DIAGRAM #4

1984 Earnings Contributions to Consumer Prices

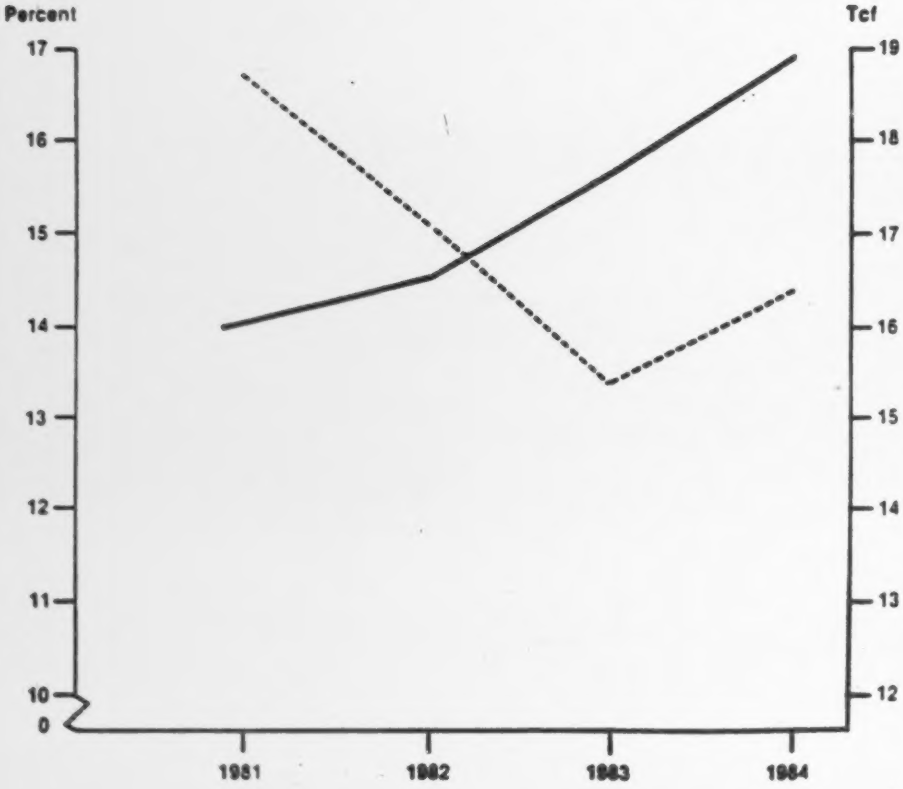


Source: Federal Energy Regulatory Commission

Natural Gas Supply Association

DIAGRAM #5

25 Pipelines Rates of Return
vs
Total Deliveries



—Rates of Return on Common Equity (Weighted Average)

--Total Deliveries

Source: Federal Energy Regulatory Commission

Natural Gas Supply Association

APPENDIX A

NATURAL GAS SUPPLY ASSOCIATION

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November 18, 1985

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FEDERAL ENERGY

HAND DELIVERY

Honorable Kenneth F. Plumb
Secretary
Federal Energy Regulatory
Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

Re: Docket No. RM85-1-000 (Part D). Supplemental Comments

Dear Mr. Plumb:

Enclosed for filing in the above-referenced proceeding are an original and fourteen copies of the "Supplemental Comments of the Natural Gas Supply Association."

We anticipate having available additional material in this docket by early next week which will compliment the comments which we are submitting today. We would appreciate the Commission's consideration in making these additional comments part of the record.

Please file stamp the extra copy of this document and return it to our messenger. Thank you for your cooperation.

Respectfully submitted,

Nicholas J. Bush

Nicholas J. Bush, President
Natural Gas Supply Association

NJB/kb

Enclosures

Representing the Nation's Producers of Natural Gas

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas)
Pipelines After Partial) Docket No. RM85-1-000
Wellhead Decontrol) (Part D)

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SUPPLEMENTAL COMMENTS OF THE NATURAL GAS SUPPLY ASSOCIATION

The Natural Gas Supply Association (NGSA) submits these comments in response to the Notice Requesting Supplemental Comments on the proposed block billing regulations (Supplemental Notice) issued by the Commission on October 9, 1985, simultaneously with Order No. 436. NGSA is an association of companies engaged in the business of exploring for and producing natural gas. NGSA members produce approximately 90 percent of all domestic natural gas.

All correspondence and communication regarding this matter should be addressed to:

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I. INTRODUCTION

NGSA strongly opposed block billing in its comments in response to the initial Notice of Proposed Rulemaking (NOPR) in this docket.* NGSA's position was based upon its conclusion, reached after careful study, that the proposal would provide few, if any, benefits, whereas it would create a new system of unjustified price distortions and discrimination among consumers, result in significant reductions of domestic supply and substantially increase imports of gas and oil. NGSA commends the Commission for the prudence it has demonstrated by withholding block billing from Order No. 436 for further public examination and comment.

During the brief period provided for the submission of supplemental comments, NGSA has undertaken significant further study of block billing to examine its theoretical underpinnings and to quantify its likely supply and price effects. The results of that study, discussed below and contained in the appendices, reinforce NGSA's initial conclusions. Careful examination demonstrates that block billing, even as now revised, would frustrate the Commission's own goal of achieving fair and efficient competition in the industry. It would, moreover, result in substantial and unjustified revenue losses to the producing industry and, thereby, in a serious disincentive for the development of the additional supplies which are necessary to replace the nation's rapidly depleting reserves. For these reasons, the proposal does not satisfy the Commission's own criteria for a just and reasonable rate or practice under the Natural Gas Act (NGA) and constitutes unwise public policy.

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* See Comments of Natural Gas Supply Association, Dkt. No. RM85-1-000 (Parts A-D) (filed July 15, 1985), at 6-13.

In the Supplemental Notice, the Commission describes what it perceives to be serious market problems and distortions inhibiting competition in the industry. NGSA believes that the only real solution to the problems the Commission has identified is the unqualified and total decontrol of natural gas prices at the wellhead. Decontrol would not only achieve the Commission's goal of facilitating efficient and fair competition, it would also provide significant benefits to the consuming public in the form of enhanced security of supply at the least cost. Additionally, given recent experience with the effects of oil decontrol in 1981 and partial decontrol under the Natural Gas Policy Act of 1978 (NGPA) at the commencement of this year, no "fly up" of prices would result from immediate comprehensive decontrol of natural gas prices at the wellhead.* When the benefits of decontrol are compared with the adverse effects of block billing, it is clear that decontrol is the pro-consumer policy and block billing is, in fact, an anti-consumer policy.

Concededly, however, the Commission lacks the legal authority to "legislate" decontrol. But there are steps that the Commission can take to mitigate the effects of below-market wellhead price regulation during the period of transition to a more fully competitive industry. This can be accomplished by (1) allowing all consumers access to a greater amount of least cost supplies, and not just those consumers with an historical advantage, and (2) increasing incentives for parties to negotiate away artificial variations in purchased gas costs resulting from the persistence of below-market price regulated natural gas. To these ends, the Commission can combine its authority under the NGPA to apply diligently the standards of just and reasonableness to raise ceiling prices on below-market regulated gas with pre-granted abandonment where parties to a certificated sale cannot agree upon a renegotiated price within the prescribed ceiling.

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* See Department of Energy, The Second Report Required by Section 123 of the Natural Gas Policy Act of 1978 (Jan. 1985), at S-7 (hereinafter "DOE's Second Report").

NGSA identifies herein a number of workable programs that the Commission might adopt to adjust price ceilings to a higher just and reasonable level. These programs are not presented in the place of comprehensive decontrol, which is the only sure means of eliminating the market distortions resulting from wellhead pricing policies. Nevertheless, by exercising its authority to raise price ceilings, the Commission can attack the problem of below-market price regulation head-on, rather than simply, and ineffectually, attempting to push the problem induced by an historically skewed set of federal regulations down to the state level. NGSA is in no way implying, though, that the only choice is between block billing and raising old gas prices. Our arguments also show that implementing Order 436 without block billing is far superior to implementing Order 436 with block billing, and that block billing is unneeded, unlawful and would be harmful to producers and consumers.

For the reasons stated herein, NGSA believes that the Commission must and will unconditionally abandon block billing. In the event, arguendo, that the Commission nevertheless insists on going forward with some form of block billing, it should amend the proposal to reduce the damage that will inevitably result. Specifically, the Commission should establish the NGPA Section 109 ceiling, as adjusted for inflation, as the just and reasonable ceiling price for below-market priced (Section 104 and 106(a)) gas included in Block 1. This price would be enforceable to the extent permitted by existing or amended contracts. In addition, where a contract has expired or, where the contract has no fixed term, twenty years from inception, and the parties are unable to agree upon a renegotiated price within the prescribed ceiling, the seller should obtain pre-granted abandonment and the ability to make a new sale. Through this alteration of the block billing proposal, the Commission would reduce the revenue losses to producers and, thereby, mitigate to some extent the adverse supply consequences that are certain to result. NGSA wishes to reiterate, however, that it does not view this modified form of block billing as an acceptable alternative to complete decontrol or the establishment of a new just and reasonable ceiling on below-market price regulated gas in the context of full rolled-in pricing.

II. BLOCK BILLING FAILS THE COMMISSION'S OWN CRITERIA OF JUST AND REASONABLENESS.

The Supplemental Notice cites, among other things, Section 5 of the NGA to support the Commission's authority to implement block billing. That section provides that, once the Commission finds a rate or practice to be "unjust [or] unreasonable", it "shall determine the just and reasonable" rate or practice to be enforced. 15 U.S.C. § 717d (1976). The Supplemental Notice sets out a four-part test to determine whether a rate or practice is just and reasonable under Section 5. To satisfy the test, a rate or practice must (a) promote "efficiency in both production and consumption of natural gas", (b) "permit 'fair' competition", (c) avoid "the wasteful depletion of natural gas" and (d) accomodate "to changing conditions" in the industry. (Supplemental Notice, at 16-17.)

Block billing fails each of these tests. The Supplemental Notice assumes that the proposal will further the Commission's goals of achieving a fair and efficient competitive market by eliminating below-market priced gas from the marginal decisions of consumers and producers. But, as discussed below, far from achieving these goals, block pricing will (i) make even worse an already bleak supply outlook, (ii) create a system of price distortions and discrimination among consumers and (iii) fail to levelize "the playing field" of competition among pipelines. Since the proposal does not satisfy the requirements for a just and reasonable rate or practice under the NGA and, moreover, frustrates the Commission's own policy goals, it should be rejected.

A. Block Billing Would Have a Severe Detrimental Impact Upon the Development of Additional Supplies of Domestic Natural Gas.

Even without block billing, the domestic supply picture is worrisome. The nation has not replaced the reserves it produced during any year since 1981. According to the Energy Information Administration's reserve estimates, reserves declined an additional 3 trillion cubic feet in 1984, descending to their lowest level since World War II. (Appendix A, Schedule 4.) The record for 1985 is likely to be even worse. As a result of already low and continually falling prices, the number of drilling rigs in operation developing new sources of supply has declined from an average of 3,970 in 1981 to approximately 1,840 in October 1985.* This represents a 54 percent drop in the rig count from the last year in which reserve additions equalled production.

Block billing would make the situation far worse by substantially reducing incentives to producers to continue to explore for and produce natural gas. The Commission has recognized that the creation of two blocks of gas, as it is proposing, provides an entirely new purchasing opportunity and makes the benefits of that opportunity retroactive. Whereas, under rolled-in pricing, pipeline sales customers see only a single price (the weighted average cost of gas), block billing would allow them not only to distinguish between two component parts of the gas stream, but selectively to elect to purchase only the below-market priced, i.e., the Block 1, component.

Foster Associates, Inc., on behalf of NGSA, was asked to assess what would happen to the cost of the higher priced component, the Block 2 gas, based upon its assessment of the competitive pressures in the market, its forecast of new gas prices and the effect that such forecasted prices would have on supply. In general,

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* Source: Hughes Tool Company.

Foster Associates concluded that by isolating the full brunt of competitive forces on only Block 2 supplies, Block 2 prices would fall more precipitously than they would in a purely competitive and efficient market. First, Foster Associates concluded that there would be substantial competition among Block 2 suppliers to the same market. In addition, Block 2 gas would not be able to compete incrementally with direct gas purchases by distributors or with No. 6 fuel oil. For example, in a comparison of 12 selected cities, Foster Associates has demonstrated that a 39¢ to 98¢ per MMBTU reduction in Block 2 prices would be required to make Block 2 gas competitive. (Appendix A, at 19, Table 6.) A spot gas comparison based on gas-on-gas competition would further reduce Block 2 prices to as much as $2.00 per MMBTU. (*Id.*, at 18.)

In terms of an explanation for these reductions, recent interstate pipeline actions to market-out producer contracts and to declare *force majeure* conditions without contract authority demonstrate that pipelines would attempt to force Block 2 price reductions. As demonstrated in Chart No. 2 of the Foster Associates study, pipeline market-outs and *force majeures* have tracked SMP and spot gas prices, and also currently track the new interstate contract price of $2.60 per MMBtu. With the introduction of block billing, the Commission has asserted that Block 2 prices would be reduced. At the same time, producers would continue to receive below-market prices for their Block 1 gas.

Appendix A contains the study performed by Foster Associates, which projects that block billing would reduce producer revenues by between $5.3 billion to $17.1 billion over the period 1986 through 1990. (Appendix A, at 25, Table 9.) Those figure should be contrasted with the $18.7 billion investment that was necessary to drill 28,294 gas well completions in 1981, the last year in which reserve additions replaced production.* A revenue loss of that magnitude, in an industry already experiencing reduced capital investment, can only result in a drastic decline in drilling activity. Foster Associates found that lower producer revenues would reduce petroleum exploration and development expenditures and lead to a reduction in reserve additions of 1.8 to 5.8 Tcf over the same period. By 1990, the lower reserve additions amount to as much as a 500 Bcf per year reduction in gas production capacity. (Appendix A, at 27, Table 10.)

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* Well Completions and Footage Drilled in the United States 1970-1982, American Petroleum Institute, January 1985, at 1 (includes dry gas wells).

The disincentive to additional production activity would be aggravated by the regulatory uncertainty created by block billing. NGSA believes the Commission does not have the authority to impose incremental pricing on all pipeline sales. But putting the issue of legal authority aside, there can be no doubt that since the time of enactment of the NGPA, and going a long way back even before then, producers have been making investment decisions in reliance upon a continued regulatory framework of rolled-in pricing. Despite the isolated examples of situations in which the Commission chose not to apply rolled-in pricing in the unique circumstances presented (*see* Supplemental Comments, at 29-30), this block billing proposal is the first time that the Commission has indicated an intention to break faith with this historical practice on an industry-wide basis.

In this way, block billing would have its greatest effect *retroactively*. It would place artificial downward pressure on prices for gas supplies that were developed in expectation of the continued regulatory *status quo*, including increasing decontrol.

Compounding these adverse supply effects is the tremendous loss of reserves that would result from the continuation of below-market ceiling prices on Block 1 gas. The DOE estimated in its Second Report Required by Section 123 of the NGPA (at S-7), that the continuation of below-market price controls would result in the permanent loss of 27 Tcf to 48 Tcf of reserves. Block billing, by forever institutionalizing these inefficient price controls, would ensure that these reserves would never be recovered.

Even apart from block billing's adverse effects upon the future development of additional supplies, the proposal could also result in the wasteful loss of existing reserves. Despite the Commission's assertion that it does not intend through block billing to regulate unlawfully the production of gas in the field (Supplemental Notice, at 25), NGSA cannot use strong enough terms to warn of the proposal's real potential to result in overly-rapid depletion of below-market price regulated reserves. This is because customers with entitlements to Block 1 gas would likely insist that pipelines attempt to maximize their takes of such gas so that the greatest amount possible of cheap gas would be available to such customers. It would also be in the interest of pipelines

-- especially those pipelines that become subject to the new contract demand reduction/conversion option -- to attempt to maximize their Block 1 takes, so that they could thereby maximize their through-put volumes. In production of a resource like natural gas, maximization and optimization of production can be in direct conflict. To the extent consumers and pipelines are successful in obtaining higher takes of Block 1 gas than that appropriate to optimize production from the reservoir, permanent reserve losses could occur.

"Exhibit S" to the Supplemental Notice contains a theoretical economic analysis that purports to demonstrate that block billing would not result in a shortage of gas. As demonstrated in Dr. Carpenter's critique (Appendix B), however, the assumptions and conclusions of "Exhibit S" are flawed. It, inter alia, (i) does not provide an adequate description of the real-world market in which block billing would operate (see Appendix B, at 1), (ii) ignores the inefficiencies that would be caused by the proposal (see id., at 11-16) and, most importantly, (iii) takes as an overriding assumption the very conclusion of the analysis -- that block billing would result in market equilibrium (see id., at 8-9).*

But even aside from this theoretical economic analysis, common sense dictates that the history of boom and bust cycles experienced by the producing industry will continue as long as only a portion of all commercial gas supplies is permitted to respond to competitive forces. Block billing would forever remove the current 47 percent of interstate pipeline purchases from competition. (Appendix A, at 5.) Since the entire burden of signalling market forces would be placed solely on the remaining (Block 2) supplies, price variations are likely to be artificially exaggerated. The resulting swings in Block 2 prices would only serve to perpetuate the very boom and bust cycles that the Commission seeks to eliminate by its proposal.

The seriousness of these supply effects is in no way undercut by the existence of the temporary gas surplus or "bubble." The surplus is one of deliverability, not of long-term reserves. One of the Commission's own tests of just and reasonableness is whether a rate or practice is appropriate to changing conditions. (Supplemental Notice, at 17.) Whatever the effect of block billing on reducing the current surplus, its effect on the long-term adequacy of the nations reserves, as discussed above, can only be negative.

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* Thus, the Commission merely assumes away the supply implications of block billing when it states that adequate supply will follow increasing demand. (Supplemental Comments, at 57.) Supply will follow demand only in a properly functioning market. But, as demonstrated in Dr. Carpenter's analysis in Appendix B, block billing will not facilitate an efficiently competitive market.

Nor can gas imports fully ensure the availability of sufficient reserves in the future. While Canadian imports are currently, and will continue to be in the future, an important source of supply, undue reliance upon imports conflicts with the national interest. Only a strong domestic gas producing industry will prevent further strains on the nation's balance of payments and protect employment. This concern is especially important in light of the loss of approximately 350,000 jobs in the producing industry since 1982.*

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* See Statement of E.C. Broun, Jr., on behalf of the Petroleum Equipment Suppliers Association, before the Subcommittee on Energy Regulation and Conservation of the Senate Committee on Energy and Natural Resources (September 19, 1985), at 3.

B. Even as Revised, Block Billing Would Create a New System of Price Distortions and Discrimination.

In its initial comments, NGSA demonstrated that block billing would not achieve its goal of neutralizing price distortions caused by below-market price regulated gas, but, rather, would merely have the effect of transferring those price effects, in magnified form, further down the marketing chain. (See NGSA Comments, at 7-11.) In an apparent attempt to alleviate that concern, the block billing proposal has been revised to allocate Block 1 gas to all pipeline customers (firm and interruptible) during the period December 1, 1978 through December 31, 1984. (Supplemental Notice, at 73-76.) These revisions to the proposal, however, do not eliminate the source of the discrimination, i.e., that certain pipeline customers would have greater access than others to inexpensive gas supplies solely because of such arbitrary factors as the amount of Block 1 gas available to their pipeline-suppliers and the level of their historical purchases. In particular Foster Associates concluded (Appendix A, at 16, Table 5) that consumers in the central region of the United States would have a relatively larger proportion of the cheaper Block 1 gas than those in the eastern or western states. The revisions to the proposal, therefore, will not cure the price distortions which are certain to result.

NGSA also asked Foster Associates to update some of the data contained in Appendix A to its initial comments to the NOPR. This more recent information is reflected in Table 3 and Schedule 5 of Appendix A. As of October 23, 1985, the PGA filings of 26 major interstate pipelines show that, under current rolled-in pricing, the difference between the highest and lowest pipeline WACOGs is $1.56. The difference between the highest Block 2 and lowest Block 1 prices, in contrast, is $3.40. Thus, if block billing were implemented, arbitrary price differences among customers would more than double.

To the extent end-users receive any of the benefits of block billing, this price discrimination would fall most heavily upon the newest consumers, who would have no/or limited access to Block 1 gas. In economic terms, the block billing proposal would create a barrier to entry for new firms, which would decrease the efficient functioning of the market and the overall efficiency of the national economy. The effect of this discrimination would be to give certain historical consumers, especially in energy-intensive industries, an unfair competitive advantage over the new entrants. This would create a disincentive to capital investment in new concerns, as well as in enlargements to existing facilities located in areas without access to substantial quantities of Block 1 gas. For example, an industrial plant that just started purchasing gas during the past several years in response to its new availability and price stability could suddenly find itself at an increased price disadvantage relative to a competing plant that is an historical customer of the same or a deeper cushion pipeline.

Block billing would also induce historical consumers to maximize their consumption of Block 1 gas at all costs. This is especially so, given that any unconsumed Block 1 gas would be allocated to remaining historical customers and, thus, would be forever lost to the customer with the original entitlement. In this way, block pricing would encourage the wasteful depletion of Block 1 gas supplies, in direct conflict with the Commission's goal to the contrary. (See Supplemental Notice, at 17.)

Even the Commission has acknowledged, however, that historical consumers may receive no actual benefit from block billing. (See Supplemental Notice, at 23.) The decision whether to enforce block pricing throughout the distribution chain to the ultimate consumer is left entirely in the hands of LDC's and state regulatory commissions.* NGSA believes it not only odd, but bad policy, to pass off onto state agencies a problem caused by federal price regulation. In essence, two levels of "entitlement" administration are created by the proposal -- one at the federal level and one at the state level. This magnifies the administrative costs associated with the proposal and increases the opportunities to "game" the regulations. The system therefore, is inefficient and increases the risk of inter and intra-regional disparities among natural gas consumers.

In any event, the Commission has instituted no procedure to assure that LDC's do not capture for themselves, as opposed to their historical customers, Block 1 rents by increasing their margins or by using Block 1 entitlements to ward off competition for existing and potential end-use sales by pipelines and producers.

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* This is true for pipeline sales to LDC's. With regard to pipeline direct sales to end-users, the Commission lacks jurisdiction under the NGA to alter the billing method agreed to by the parties. See 15 U.S.C. § 717(b). According to the Commission's own information, a number of pipelines make substantial direct sales that could not be affected by block billing, despite the Commission's statements to the contrary. (See Supplemental Notice, at 75.) The Supplemental Notice fails even to address the effects of this jurisdictional limitation on the implementation of block billing to direct sales transactions, which was pointed out by NGSA in its initial comments. (NGSA Comments, at 8-9.)

C. Block Billing Would Not Create a "Level Playing Field" for Competition Among Pipelines.

One of the principal arguments used to justify block billing is that it would create a more "level playing field" for competition among pipelines. (NOPR, at 10-11; Supplemental Notice, at 22.) According to this theory, block billing would remove the "old" gas cushion as a distorting influence and require pipelines to compete only with their market-responsive Block 2 gas supplies. Competition for sales among pipelines would then allegedly be based solely upon the business acumen of pipeline management, free from the effects of below-market price regulated gas.

As with the Commission's other policy goals, block billing would also fail to achieve this level playing field of fair competition among pipelines. The Commission implicitly recognized the reason why when it conceded that, under block billing, pipelines with a "large old gas cushion. . . would be assured of a higher percentage of sales due to the amount of block 1 gas they make available to their customers, than would pipelines with less block 1 gas." (Supplemental Notice, at 25.)

As a result of the relatively high through-puts attainable by deep cushion pipelines, their per-unit transportation costs would be lower than those of other pipelines. The lower transportation costs would, in turn, provide those pipelines with a significant competitive advantage over their rivals for both new sales and transportation opportunities. Thus, even with block billing, competition among pipelines would still be distorted by the effects of below-market price regulated gas.

Moreover, as Dr. Carpenter notes in Appendix B (at 14-15), block billing would create a new system of competitive disequilibrium. By providing LDC's and selected direct industrial customers with the benefits of old gas rents, block billing would provide them with an artificial advantage in bidding for new gas supplies. Given the increased number of transactions that would occur as direct purchases by LDC's and industrial consumers become more common, this new system of unfair competition could, in fact, create more serious problems than those identified by the Commission in the Supplemental Notice.

III. IN THE ABSENCE OF COMPREHENSIVE DECONTROL, THE COMMISSION CAN MITIGATE THE DISTORTING EFFECTS OF PRIOR REGULATORY POLICIES BY RAISING BELOW-MARKET PRICE CEILINGS.

The purpose of the block billing proposal is primarily to diminish what the Commission perceives as serious market distortions that inhibit fair and efficient competition in the industry. (*See* NOPR, at 10-11.) As discussed above, block billing would not achieve that result and, in fact, would only make matters worse. The Commission could ease the industry's on-going transition to a more fully competitive environment by increasing the pool of terms and contracts available for negotiation between the parties concerned. This can be accomplished by raising below-market price *ceilings* to a higher just and reasonable level and providing producers with pre-granted abandonment authority where the parties to a certificated sale cannot agree on a renegotiated price within the ceiling restrictions.

A. Only Comprehensive Wellhead Price Decontrol Would Achieve the Commission's Goal of Fostering Fair and Efficient Competition in the Industry.

NGSA believes that the only viable means to a more fully competitive industry is the total decontrol of natural gas prices. Decontrol would eliminate the pernicious effects of below-market price ceilings on a substantial portion of the nation's gas supplies and would, thereby, permit the efficiencies of the market to govern supply and demand. Furthermore, decontrol is consistent with the Commission's own conclusions in Order No. 436 that natural gas is a commodity and should be treated as such:

> The key conclusion which flows from this fact is that *price* signals for natural gas play the same role in stimulating or dampening supply as they play in other commodity markets. Accurate, responsive price signals are thus not a matter for mere academic concern but a matter of commercial life and death for the production industry.

(Order No. 436, at II-7; emphasis in original.)

Decontrol would also result in the development of tremendous additional reserves. Below-market price controls eliminate incentives to maximize the productive capability of reserves subject to those controls. As noted above, the DOE estimates that decontrol would add approximately 27 Tcf to 48 Tcf of additional reserves to the nation's supply.

This benefit to consumers of increased supply security, moreover, would be achieved without a "fly-up" in gas prices. In the past five years this nation has twice experienced the removal of price controls from energy commodities. The first experience occurred when President Reagan decontrolled oil prices in January 1981. The second experience occurred more recently in January 1985, when certain categories of natural gas were decontrolled pursuant to the NGPA. Prior to both instances, various interest groups made dire predictions that a "fly-up" of prices would result irrespective of market conditions. History has discredited those predictions. In fact, both oil and gas commodity prices have been falling in recent years. Given current market conditions, there is no reason to believe that the result of total decontrol of natural gas would be any different from that of these prior experiences.

Indeed, consumers would receive a substantial dollar benefit from decontrol. Over a twenty year period, consumers would save approximately $25.3 billion in net savings from the substitution for imported oil of the additional gas supplies developed as a direct result of decontrol.* This would also improve the nation's balance of trade over the next ten years by approximately $50.5 billion.** When the increased supply security, consumer dollar savings and balance of trade effects are considered, decontrol must be viewed as the ultimate pro-consumer gas pricing policy.

B. Within the Scope of Its Legal Authority, the Commission Can Ease the Transition to a More Fully Competitive Industry by Combining Adjustments to NGPA Price Ceilings with Pre-Granted Abandonment Authority to Producers.

Concededly, the Commission does not have the legal authority to decontrol comprehensively natural gas prices. The Commission does, however, have the authority to mitigate the distorting effects of below-market price controls during the transition to a more fully competitive industry by (1) allowing all consumers access to a greater amount of the least cost supplies, and not just those consumers with an historical advantage, and (2) by increasing incentives for parties to negotiate away artificial variations in purchased gas costs. This can be achieved by implementing higher ceiling price levels on below-market price regulated gas and providing producers with pre-granted abandonment and the authority to make new sales where parties to a certificated sale cannot agree on a renegotiated price. The NGPA provides the Commission with clear authority to raise the NGPA below-market ceiling prices (currently gas subject to Sections 104 and 106(a) of the NGPA) to new just and reasonable levels.* The Commission has already acknowledged this authority.** The Supplemental Notice (at 21) inexplicably ignores these long-standing statutory provisions and incorrectly assumes that Congress' intent was forever to maintain below-market price ceilings at levels set in 1976, regardless of their adverse effects. By exercising this authority, the Commission can ease the transition to a more fully competitive industry, rather than exacerbating the distortions identified by the Commission in the Supplemental Notice, as it would if it adopted block billing.

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* *See* Statement of Donald G. Russell, Vice-President of Shell Oil Company before the Subcommittee on Fossil and Synthetic Fuels of the House Energy and Commerce Committee, November 13, 1985.

** *Id*.

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* See 15 U.S.C. §§ 3314(b)(2) and 3316(c) (1982).

** See Impact of the NGPA on Current and Projected Natural Gas Markets (Notice of Inquiry) Dkt. No. RM82-26, II FERC Stat. & Reg. ¶ 35,512 at 35,565 (1982).

C. The Commission Can Adopt Any of a Number of Workable Programs to Raise Below-Market Price Ceilings to a Higher Just and Reasonable Level.

Three alternative proposals are set out below for consideration by the Commission. Each proposal would ease, in varying degrees, the transition to a more fully competitive industry by combining adjustments to below-market (Section 104 and 106(a)) price ceilings with pre-granted abandonment authority where the parties to a certificated sale cannot agree on a renegotiated price. These proposals are illustrative of the flexibility the Commission has to structure a program that best meets the regulatory goals outlined in Order No. 436. Short of comprehensive wellhead price decontrol, none of these proposals would completely eliminate market distortions. But they all, in stark contrast to block billing, attack those distortions head-on in a manner consistent with the Commission's legal authority and the criteria of just and reasonableness set out in the Supplemental Notice. In addition, adoption of this approach would create a clear signal that the below-market priced commodity could not be used to unfair advantage by one pipeline which had a greater regulatory endowment over another pipeline with a lesser regulatory endowment. The following three approaches, which are provided in no particular order, would, moreover, reinforce the sanctity of contracts by providing sellers an opportunity through pre-granted abandonment to terminate deliveries at the end of a contract unless a new contract is renegotiated and by increasing the incentives for parties to renegotiate all contracts closer to market prices.

PROPOSAL 1

A. Establish the NGPA Section 109 ceiling, as adjusted for inflation, as the new just and reasonable price ceiling for all below-market priced regulated gas (Sections 104 and 106(a)).*

B. The new just and reasonable ceiling price would become applicable to all below-market priced regulated gas:

   1. whenever the first seller and purchaser mutually agree to amend a contract to increase the price up to the new ceiling; or

   2. at the time the contract covering such gas expires by its terms or, in the case of contracts not containing a fixed term of

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* The NGPA Section 109 price is a legally supportable just and reasonable ceiling price, since it was the ceiling adopted by the FPC in Order No. 770-A, 56 FPC 2698 (1976), and was incorporated into the NGPA. By applying the NGPA Section 109 ceiling to all categories of below-market priced regulated gas, the Commission, in effect, would eliminate the vintaging concept incorporated in FPC Order No. 770-A. As discussed in the joint comments of the Indicated Producers in response to the Notice of Inquiry in FERC Docket No. RM82-26, the Commission has clear legal authority to collapse the Order No. 770-A vintages.

years, twenty years after the initial effective date.

3. If the parties cannot agree on renegotiated terms at the expiration of a contract, or, in the case of contracts not containing a fixed term of years, twenty years after the initial effective date, the first seller would be authorized to abandon the sale and would be provided with certificate authority, where necessary, to make a new sale.

C. In the case of gas subject to a contract that has already expired and not been renewed, the first seller and purchaser would have a one year period from the effective date of the new rule to renegotiate an acceptable price, after which, if no agreement is reached, the seller would be authorized to abandon the sale.

D. The NGPA Section 109 ceiling is proposed as a final ceiling price. If, however, the Commission believes that further proceedings are appropriate before determining a final just and reasonable ceiling, the NGPA Section 109 ceiling should be adopted as an interim ceiling pending the outcome of those proceedings. In no event should the Commission delay implementation of an interim just and reasonable ceiling pending the outcome of whatever further proceedings the Commission believes are appropriate.

PROPOSAL 2

A. Establish the NGPA Section 109 ceiling, as adjusted for inflation (see PROPOSAL 1, parts A and D above), as the new just and reasonable ceiling for all below-market price regulated gas.

B. The new ceiling rate would go into effect immediately.

1. Upon implementation of the new ceiling rate, the seller would have the option to collect under existing contract authority the new rate, but would be required to allow the buyer to terminate the contract for economic reasons.

2. If the option is exercised by the Buyer to terminate the contract, abandonment of the purchase and sale would be granted.

3. Abandonment authority would also be pre-granted to contracts at expiration of the contract.

PROPOSAL 3

A. Establish the NGPA Section 109 ceiling, as adjusted for inflation (*see* PROPOSAL 1, parts A and D), as the new just and reasonable ceiling price. Also establish a new *minimum* area rate commenserate with market considerations and replacement costs.

B. The collection of the new ceiling would be subject to specific contractual authority that would be negotiated by buyers and sellers under the program.

C. Pre-granted abandonment authority would be established upon the expiration of the contract or where the parties could not agree upon a renegotiated price in accordance with B above.

IV. IN THE EVENT, *ARGUENDO*, THAT THE COMMISSION INSISTS ON GOING FORWARD WITH BLOCK BILLING, IT SHOULD AMEND THE PROPOSAL TO MITIGATE THE DAMAGE THAT IT WILL CAUSE.

NGSA strenuously urges the Commission to abandon unconditionally the block billing proposal. As stated above, block billing would not achieve the Commission's goals, but rather would only create a new system of price distortions and discrimination among customers, result in significant reductions of domestic supplies and substantially increase imports of gas and oil. The proposal is, therefore, unwise and unlawful.

In the event, arguendo, that the Commission nevertheless insists upon adopting some form of block billing, it should amend the proposal contained in the Supplemental Notice to mitigate the damage that is certain to result. The ill effects of block billing can be reduced only if the Commission allows Block 1 prices to rise by exercising its authority under the NGPA to establish a higher just and reasonable level for below-market priced Block 1 gas. Specifically, the Commission should:

A. Establish the NGPA Section 109 ceiling, as adjusted for inflation, as the new just and reasonable price ceiling for all below-market priced Block 1 gas (Sections 104 and 106(a)). Section 104 and 106 prices should be adjusted upward to offset the revenue losses to producers resulting from the decline in Block 2 prices. This price would be enforceable to the extent permitted by existing or amended contractual authority, with it being understood that gas sold under expiring contracts, expired contracts or contracts having no fixed term and extending more than twenty years from inception will likewise qualify for the Section 109 price.

B. Should the parties be unable to agree on a renegotiated price within the ceiling upon expiration of a contract, or after twenty years for contracts containing no fixed term, the seller would obtain pre-granted abandonment and

> the ability to sell the gas to an alternate market.

By this mechanism, the adverse supply effects and price distortion certain to result from block billing would to some extent be reduced.

NGSA wishes to reiterate, however, that it does not view this modified form of block billing as an acceptable alternative to complete decontrol or the establishment of a new just and reasonable ceiling on below-market price regulated gas in the context of full rolled-in pricing. NGSA suggests the combination of block billing with the raising of price ceilings on Block 1 gas only as a means of limiting the adverse effects of block billing.

V. SUMMARY

The Commission should abandon block billing. Its theoretical underpinnings are flawed and the proposal would frustrate the Commission's stated goal of achieving a fair and efficient competitive environment in the industry. On the contrary, it would result in severe disincentives to the future development of additional gas supplies and would also create a new system of price distortions and discrimination among consumers. For these reasons, block billing is not only bad policy, it is also illegal under the criteria for a just and reasonable rate or practice set out by the Commission in the Supplemental Notice. Therefore, Order No. 436 should be freed of this unneeded and unlawful addition that would harm both producers and consumers.

The only policy sure to achieve the Commission's goal of enhancing fair and efficient competition is the comprehensive decontrol of all wellhead prices. The Commission's authority, however, is more limited. It can only mitigate the effects of prior regulatory policies and ease the transition to a more fully competitive industry. It can do this by (i) raising below-market price ceilings to a higher just and reasonable level and, (ii) where agreement among the parties on a renegotiated price level within these ceilings cannot be reached, providing producers with pre-granted abandonment authority and the ability to make new sales. NGSA has proposed a number of workable programs which can be adopted by the Commission to this end.

In the event, *arguendo*, that the Commission insists upon adopting some form of block billing, the Commission should amend the proposal to reduce the damage it would certainly cause. It can do this by raising just and reasonable price ceilings on Block 1 gas and making the new price applicable wherever permitted by existing or amended contracts, as well as to all expired or expiring contracts and, in the case of contracts with no fixed term, twenty years after the initial effective date. By doing so, the Commission would reduce the revenue losses to producers and, thus, would mitigate block billing's severe adverse supply consequences.

Respectfully submitted,

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November 18, 1985

APPENDIX A

Docket No. RM85-1-000
(Part D)

ANALYSIS OF BLOCK BILLING
RE: FERC DOCKET RM85-1

Prepared For:

Natural Gas Supply Association

Prepared By:

William G. Foster
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Foster Associates, Inc.

November 1985

ANALYSIS OF BLOCK BILLING
RE: FERC DOCKET RM85-1
EXECUTIVE SUMMARY

The FERC seeks to modify the structure of the natural gas industry by block billing. FERC hopes that block billing will (1) mitigate market distortions caused by the availability of low cost gas, (2) instill greater competition in the marketplace, and (3) provide a better mechanism to send signals from consumers to suppliers.

However, to implement block billing is to implement a new layer of regulation on the U.S. natural gas industry at a time when market forces are resolving problems created by years of over regulation. It is unlikely that block billing will resolve the remaining market problems, but it surely will have adverse effects on the gas industry.

To address any market problems which still exist, it is preferable to get to the crux of the problem (e.g., low price controlled gas) rather than to continue to cover the problem up with a new ad hoc regulatory program. To get to the crux of the problem is to increase old gas prices to a "just and reasonable" level, a level that instills competition, encourages economic efficiency, reflects replacement cost and responds to dynamic changes in market conditions.

The following recent developments demonstrate the results of market forces in correcting problems that have arisen in many U.S. markets.

- High cost gas prices have sharply declined since 1981/1982, e.g., NGPA Section 107 gas prices are currently $4.14 per MMBtu compared to $7.31 per MMBtu in 1982.

- Purchases of high cost Section 107 gas volumes have declined from 1 Tcf per year in 1983 to 0.5 Tcf in 1985.
- The average price of new gas has declined from $4.02 per MMBtu in 1984 to a current level of $3.42 per MMBtu.
- Many new purchase contracts contain market sensitive pricing provisions, e.g., since January 1, 1982, 80 percent of all NGPA Section 102 and 107 interstate contracts have market sensitive pricing provisions.
- Other market developments that have promoted competition in the industry are: recent competitive pricing of Canadian gas exports and new transportation programs that allow distributors and end-users direct access to gas supplies.

Implementation of block billing is too late to resolve market problems. Market forces themselves are achieving the effects block billing would address far more efficiently than could be achieved by new regulatory programs. Moreover, block billing will probably result in additional problems for the industry. For example, ongoing current negotiations in the industry (as evidenced from the market trends described above) would be hampered if block billing were to be implemented.

A further adverse effect of block billing would be its impact on the future U.S. supply situation. Currently the U.S. has a gas deliverability surplus; however, it does not have a reserves surplus. In fact, U.S. reserves are at the lowest level that they have been for about 40 years. In only two of the years since 1968 have new reserves additions in the Lower 48 States replaced annual U.S. production.

New gas prices in the U.S. are at low levels and this fact has seriously reduced the industry's exploration and development efforts. For example, the average initial price of interstate contracts executed in 1985 is $2.60 per MMBtu. Recent market out prices are ranging from $2.00 to $2.60 per MMBtu and current spot prices are about $2.00 per MMBtu, both indications that contract prices are still falling.

Implementing block billing will unnecessarily reduce U.S. gas prices, primarily Block 2 prices to below market clearing levels and set in motion a new imbalance between domestic supply and demand. The price reduction is estimated at $0.39 to $.98 per MMBtu under current market conditions.

The projected reduced gas prices as a result of block billing will cause a reduction of $5 to $17 billion in producer revenues over the 1986-1990 period. This reduced revenue results in lower funds available for exploration and development efforts, which in turn, will reduce projected gas reserves by 2 to 5 Tcf by 1990 (with a lower corresponding productive capacity of 200 to 500 Bcf per year).

It is concluded that block billing would not be as efficient as market forces in resolving persistent market problems. Market forces have proven effective in solving problems that over-regulation has created. Furthermore, to implement a new ad hoc regulatory problem such as block billing will probably disrupt ongoing progress, and will probably have an adverse impact on the natural gas industry.

It is another conclusion of this analysis that a more efficient and effective solution to the remaining natural gas market problems is to increase artificially low prices of old gas to "just and reasonable" levels rather than to impose block billing, which does not get to the crux of the problem.

ANALYSIS OF BLOCK BILLING
RE: FERC DOCKET RM85-1

I. INTRODUCTION

Foster Associates, Inc.* has conducted this analysis of the FERC block billing proposal (RM85-1) on behalf of the Natural Gas Supply Association. The major purpose stated by the Federal Energy Regulatory Commission for implementing block billing is to instill more competition in the gas industry by providing a better mechanism for sending appropriate market signals from the consumer to the producing industry. In addition, it is the purpose of block billing to "level the playing field" among the interstate pipelines so as to provide fairer competition. Further, block billing has been designed to mitigate the market and competitive distortions that currently exist from the availability of low cost old gas, e.g., the "cushion gas" problem. As proposed by the FERC, the benefits of the old gas are to be preserved for existing customers of the pipelines.

This study divides the analysis of block billing into two areas. First, we have examined the degree to which the market distortion problem currently exists, in an effort to determine if a major new regulatory program is required to resolve the market problems. Second, we also examined if additional market problems and/or other possible adverse effects may result from implementing block billing.

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* This study was prepared by William G. Foster and Radford L. Schantz, assisted by Marie Lanciotti and Rebecca Reddick.

II. THE REMAINING PROBLEM AND THE BEST SOLUTION

One of the intended purposes of block billing is to resolve the market distortions created by stringent price controls on old gas combined with rolled-in pricing. The natural gas industry and the market forces within the industry have already made substantial progress in resolving these problems. The conditions that block billing is designed to mitigate were more severe during the 1981/82 period. However, it is not necessarily the case that block billing is better late than never, but rather a case that the program should not be implemented at all because of its potentially adverse impacts on the industry. For example, by implementing the program, the Commission could impair (and probably already has impaired) the current ongoing renegotiations of price and other contract provisions occurring within the industry.

A. Market Forces at Work Resolving the "Cushion Gas" Problem

It is alleged that the presence of the low cost gas (i.e., "cushion gas"), coupled with rolled-in pricing, has created market distortions and has curtailed market signals. However, the sharp reduction in high cost gas prices over the past few years is evidence that market forces are at work resolving this problem, and evidence that a new regulatory program is not required. The trend in high cost gas prices since 1981 is shown below:

Table 1*

TREND IN PRICES OF HIGH COST GAS[a]

Year	$/Mcf
1981	$6.58
1982	7.31
1983	6.25
1984	5.38
11/85	4.14

a/ Average projected interstate NGPA Section 107 prices.

Source: Current Purchased Gas Costs of Interstate Pipeline Companies, published by Foster Associates, Inc.

These reductions in the high cost gas price are a result of numerous factors, including renegotiation of high cost gas contracts, new contracts with market sensitive price provisions, unilateral actions taken by interstate gas buyers such as market-outs, force majeure actions and reduction of takes of high cost gas.

As shown, the average projected price of NGPA Section 107 gas in 1981 was $6.58 per Mcf and it increased to $7.31 per Mcf in 1982. Thereafter, there was a continuous decline of the average NGPA Section 107 price to $4.14 per Mcf by November 1985.

In addition to the sharp reduction in NGPA Section 107 prices over this period, the projected purchase volumes of this high cost gas fell from about 1 Tcf in 1983 to current levels of just over 500 Bcf on an annual basis. The 500 Bcf represents only 3 percent of total U.S. gas production.

It has not only been the Section 107 gas but also the Section 102 gas prices which have commenced to reflect market conditions. Section 102 prices increased steadily, essentially

* "Tables" refer to material within the text.
"Schedules" refer to material in the Statistical Appendix.

following the NGPA price ceiling until January 1, 1985. Market forces commenced to reduce decontrolled NGPA 102 prices after January 1, 1985. The current average decontrolled Section 102 price is $3.24 per MMBtu, 20 percent below the current NGPA Section 102 ceiling. (Total average Section 102 price, including that remaining under price controls, is $3.42 per MMBtu as of November 1, 1985.) See Schedule 1 of the Statistical Appendix.

The average price of all Block 2 gas under the FERC block billing proposal has recently fallen as well, as would be expected since the bulk of this gas is Sections 102 and 107 gas. For example, the current average Block 2 price is $3.42 per MMBtu compared with an average of $4.02 per MMBtu as estimated for Block 2 volumes in 1984. In fact, from June to October 1985, the Block 2 price has fallen from $3.60 to $3.42 per MMBtu.

Two important additional factors related to the resolution of the market problems by the industry itself rather than increasing regulations are (1) the increasing proportion of new gas contracts with market sensitive pricing provisions and (2) the depletion over time of the low cost cushion gas volumes which at one time were available to counterbalance the high cost gas purchases.

Table 2 demonstrates that almost 80 percent of newer (post 1/1/82) contracts for purchases of Section 102 and 107 gas volumes have market sensitive pricing provisions within the contracts. In contrast, contracts executed prior to 1/1/82 generally do not have such market sensitive pricing.[1]

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[1] The data on Table 2 represent prices as filed in PGAs that were in effect in mid 1985. Foster Associates has subsequently updated these data which were originally compiled for the American Gas Association. The update shows that the average price of the market responsive gas is $2.82 per MMBtu, representing 53 percent of the total Section 102 and 107 volumes.

Table 2

SUMMARY OF NGPA SECTIONS 102 AND 107
INTERSTATE PIPELINE GAS PURCHASES
BY CONTRACT DATE
(Mid 1985)

Pre Jan. 1, 1982 Contracts	Volume (12 Months) (MMcf)	Price ($/MMBtu)
Market Sensitive	713,302	$ 3.12
Non-Market Sensitive	1,561,895	4.49
Total	2,275,197	4.05
Post Jan. 1, 1982 Contracts		
Market Sensitive	963,494	$ 2.95
Non-Market Sensitive	233,404	4.50
Total	1,196,898	3.26
Total		
Market Sensitive	1,676,796	$ 3.02
Non-Market Sensitive	1,795,299	4.49
Total	3,472,095	3.78

Source: Foster Associates' Online PGA Data Retrieval Service.

While low cost cushion gas continues to be a significant portion of the U.S. interstate gas supply, it is of less importance than in past years. As of the end of 1984, reserves of low cost gas were 33 Tcf, representing 37 percent of total interstate contracted domestic gas reserves. Current expected purchases of this gas total 4.2 Tcf, or 47 percent of total interstate field purchases, at an average price of $1.46 per MMBtu (see Schedule 1 of Statistical Appendix). These volumes are expected to decline over time, projected at 2.3 Tcf in 1990.

B. Other Recent Market Factors Creating a Competitive Environment

In addition, other evolutionary changes in the gas industry have made this proposed regulatory program untimely and inappropriate:

- o The decline of the deliverability surplus (and the U.S. reserves position at year end 1984 at the lowest level in post-war history).

- o The recent establishment of a competitive pricing policy for Canadian gas exports to the U.S.

- o The reduction of U.S. new contract and spot gas prices to unprecedented low levels since passage of the NGPA.

- o The new transportation programs to allow distributors and end-users to make direct gas purchases.

To elaborate on each of these changes:

Deliverability Surplus & Domestic Reserves Position

Currently the U.S. gas market is in a deliverability surplus; however, this surplus has decreased over the last two years. A distinction should be made between a deliverability surplus and a reserves surplus. The U.S. is not in a reserves surplus. Therefore, any new regulatory program that might curtail industry exploration and development efforts for new reserves should not be implemented.

Two recent estimates of the deliverability surplus and its trend are offered by the American Gas Association (AGA) and the Energy Information Administration (EIA) and are shown on Schedules 2 and 3 of the Statistical Appendix. EIA shows a six month surplus of 1.8 Tcf commencing July 1985, and AGA estimates a current 1985 surplus of 2.9 Tcf. In addition to the different time periods, the EIA estimate includes Canadian gas while AGA's estimate is domestic only. In spite of these differences, the two sources show similar trends: the gas deliverability surplus peaked in the year 1982 or 1983.[1]

Stated many times in the past, and repeated here, is the fact that the U.S. deliverability surplus is not a reserves surplus. This is important to remember when analyzing the impact of the block billing proposal, because block billing will have an adverse effect on the U.S. reserves position at the same time as U.S. reserves are at the lowest point since World War II. Thus, the U.S. will have to continue to explore for and develop new reserves to meet future requirements although we have a deliverability surplus at this time.

Schedule 4 of the Statistical Appendix shows the long term trend in U.S. gas reserves. Current U.S. Lower 48 States reserves stand at 163 Tcf, representing a reserves-to-production ratio of 9.6 years. In only two years since 1968 have reserves additions been greater than withdrawals. In fact, since 1968, the reserves additions have only replaced about 60 percent of production.[1]

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[1] It is unclear how large a U.S. deliverability surplus is needed to meet variation in weather or other unanticipated supply needs. For example, average January 1984 U.S. gas production was 52.5 Bcf per day. This, on an annual basis, represents 19.2 Tcf, only 4 percent below the AGA's deliverability capacity.

Canadian Pricing Policy

Canadian gas represents a portion of the current U.S. deliverability surplus. Presently, U.S. and Canadian regulatory authorities have approved about 1.7 Tcf per year of imports/exports. The 1984 import volumes totalled 800 Bcf and are estimated to increase to 900 Bcf in 1985. Canadian gas export pricing policy changed to a more market oriented pricing in November 1984. In addition, recent actions taken by Canadian authorities, e.g., removing the Toronto city-gate export floor price, have further assured increased competition between U.S. and Canadian gas suppliers for the U.S. markets.

The current commodity rate for Canadian gas imports averages about $2.40 per MMBtu (U.S.) with a range of $2.03 to about $2.97 per MMBtu. In addition, essentially all contracts either have biannual price redeterminations and/or commodity rate indexing with U.S. gas sources and/or competitive energy prices in U.S. markets (e.g., No. 6 fuel oil price). This market oriented pricing by the Canadians is likely to increase competition and put considerable downward pressure on U.S. gas prices.

New Gas Prices

Already, new U.S. gas prices are at low levels, and this has affected U.S. drilling activity, e.g., monthly average U.S. rig count is reported as 1,996 through September 1985, down 50 percent from the comparable 1981 level (EIA, Monthly Energy Review, July 1985).

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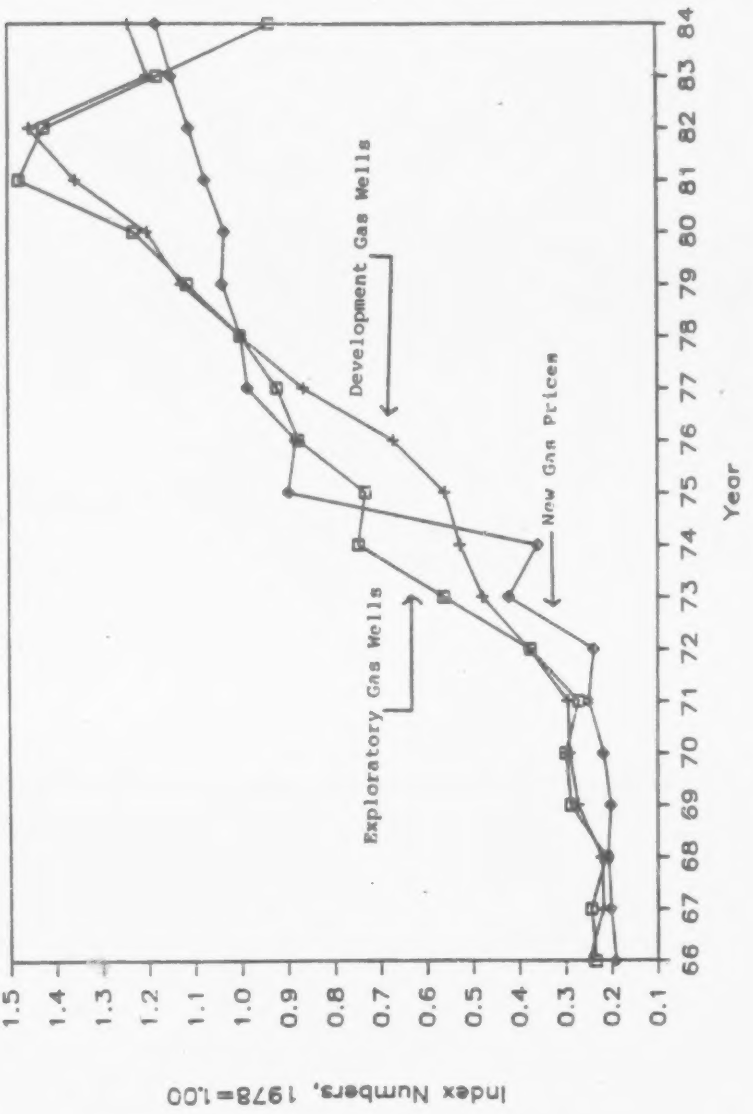
[1] Over the period since the passage of the Natural Gas Policy Act of 1978, reserves additions only equalled 90 percent of withdrawals.

Gas prices are the most important factor in determining the level of U.S. drilling activity; over the years there has been a high correlation between prices and U.S. drilling activity. This relationship, as demonstrated on Chart 1, shows the trend in new gas prices compared with successful exploratory and development gas well completions over the 1966-1984 period.

Chart 2 sets out the trend in selected gas prices since mid-1982; shown on the chart is a range of market-out prices, currently at $2.00 to $2.60 per MMBtu; SMP prices are currently at the upper end of the market-out price range, while spot prices track the lower end of the range. In addition, according to the most recent PGA filings of the interstate pipelines, the average projected new gas price for contracts executed during 1985 is $2.60 per MMBtu. This average is, of course, far below new contract prices of recent years. Therefore, it is evident that new interstate contract prices are still falling.

Chart 2 also demonstrates that interstate pipelines, through the use of market outs and force majeures, have been able to force high cost gas prices down to competitive price levels. Thus, if the block billing mechanism is implemented by FERC, pipelines can be expected to use market out and force majeures as a means to force Block 2 prices to respond rapidly to competitive price levels.

Chart 1



NATURAL GAS PRICES:DRILLING ACTIVITY

Relationship, 1966–1984

Mkt Out, SMP & Spot Price Trends

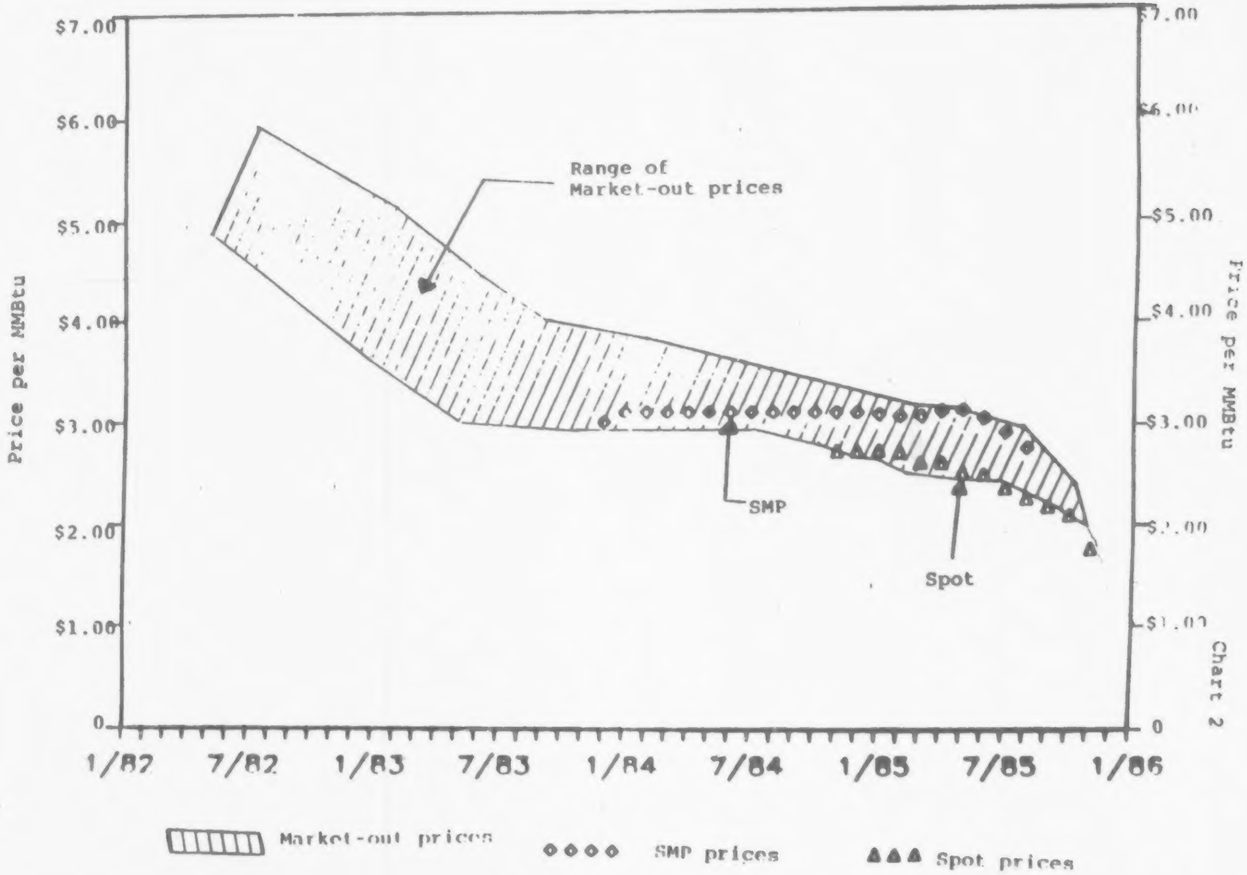


Chart 2

Transportation Programs

The last recent industry change that makes the block billing provision inappropriate is the new transportation program implemented under RM85-1. This program, coupled with the market conditions discussed above, could provide (if pipelines choose to participate) substantial opportunities for distributors and end-users to diversify their gas supply and take advantage of lower prices.[1] Already, many gas distributors generally have more than one supplier and can switch from one to another to take advantage of lower rates. During the 1983/1984 heating year, for example, 44 percent of the gas delivered to distributors in the interstate market was delivered to distributors with at least 3 suppliers (each providing at least 5 percent of a distributor's system requirements).[2]

C. Increasing Old Gas Prices As an Alternative to Block Pricing

As discussed above, competition in the U.S. gas industry has come a long way in resolving problems stemming from over-regulation in the past. If a market distortion resulting from old cheaper gas under stringent price controls still exists, then the best and most efficient means of dealing with it is to get to the root of the problem, i.e., eliminate the unreasonably low price controls. The solution is not in the implementation a whole new ad hoc regulatory program, i.e., block billing, a program which most likely will not resolve the problem. It is evident that competitive market conditions exist today which would mitigate the price impact of increasing the old gas prices to "just and reasonable" levels. The increase of old gas prices will have the positive impacts of (1) eliminating altogether the "cushion gas" distortion (2) putting additional downward pressure on high cost gas and (3) bringing forth substantial new reserves from older fields (discussed later).

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[1] In fact, even without FERC's new transportation program, U.S. pipelines have substantially increased their shipments on behalf of distributors and end-users over the past few years. INGAA reports, for example, carriage for distributors and end-users reached 355 Bcf during the first quarter 1985, 37 percent higher than the comparable 1984 period. (See INGAA, Voluntary Carriage Update, August 1985.)

[2] Based on data in FERC Form 50, 1983-1984.

In the Commission's request for supplemental comments in Part D of Docket RM85-1, four economic criteria are laid out for determination of just and reasonable rates:

(1) Rates should bring about efficiency of production and consumption, and reflect replacement costs.
(2) Rates should achieve a price that is fair and competitive.
(3) Rates should not lead to wasteful consumption of scarce resources.
(4) Rates should be able to change easily with market conditions.

Rates which incorporate artificially low price controlled gas do not fit any of the above criteria; therefore, it is logical that the artificially low gas prices cannot be considered as "just and reasonable".

Block billing does not necessarily help meet the criteria established for "just and reasonable" rates. As proposed, Block 1 gas will still be priced well below market levels, and if incrementally priced at the retail level, Block 1 rates will be (1) inefficient, (2) wasteful, of scarce resources, (3) well below replacement costs and (4) unable to change with market conditions.

Whether Block 2 gas pricing under this program is closer to meeting these "just and reasonable" rate criteria is in dispute. It depends in part on whether these Block 2 volumes are rolled-in by distributors to set the retail rates or if the volumes are sold incrementally. If rolled-in, then there is no real difference from the current condition, and all that the Commission has done is to push the cushion gas problem down the pipeline to the city gate. In addition, it depends on how low the Block 2 and new gas prices are driven down as a result of implementing the program (as discussed below).

As stated at the outset of the paper, an intended purpose of block billing is to level the playing field of the interstate pipelines. Comparison of block billing to rolled-in pricing (e.g., WACOG) shows that there will be as great or greater variations in gas prices under block billing as under the current situation.

Schedule 5 of the Statistical Appendix shows the average Block 1 and Block 2 gas prices as well as the current WACOG for major interstate gas pipelines. Pipelines are segregated by the principal region they serve.[1] Table 3 below summarizes the U.S. average gas costs under block billing. Prices are shown both at the pipeline inlet as well as the city gate by adding the pipeline's system average transmission margin.

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[1] Division of pipelines by region is not absolute; many pipelines serve more than one region.

Table 3

U.S. AVERAGE BLOCK GAS COST[a/]
($/MMBtu)

	Pipeline Inlet			City Gate		
	Block 1	Block 2	WACOG	Block 1	Block 2	WACOG
Range: High	2.38	4.36	3.53	3.08	5.22	4.38
Low	0.96	2.79	1.97	1.80	3.45	2.74
Weighted Average	1.46	3.43	2.50	2.27	4.24	3.31
Variance	0.13	0.14	0.18	0.14	0.26	0.18

a/ As of November 1985.

Source: Schedule 5 of the Statistical Appendix.

As shown on Schedule 5 of the Statistical Appendix, major variations exist within Block 1 in the East, Central and West. For example, at the city-gate, the price variation in the East for Block 1 ranges from $2.02 to $2.91 per MMBtu; from $1.80 to $3.08 per MMBtu in the Midwest, and from $1.94 to $2.54 per MMBtu in the West. The situation with Block 2 gas is even more varied than that of Block 1. In the East the delivered Block 2 gas ranges from $3.82 to $4.81 per MMBtu, in the Midwest from $3.53 to $5.22 and in the West from $3.45 to $4.40 per MMBtu.

In addition to these variations of gas costs caused by block billing, increased variation will also result from the allotments of the less expensive Block 1 gas to the pipeline's customers. Not only does this vary by pipeline customer in a specific market, but also there is a major variation across the country among different regions.

Three large gas companies serving the New York, Baltimore and Philadelphia metropolitan areas can be used to illustrate the variation of the relative importance of Block 1 volumes to a company's gas supply for companies in the same general market, as shown on Table 4.

Table 4

ESTIMATED ENTITLEMENT OF BLOCK 1 GAS SUPPLY
AS A PERCENT OF DISTRIBUTOR'S SYSTEM REQUIREMENTS

Consolidated Edison Co. of NY	29%
Baltimore Gas & Electric Co.	24%
Philadelphia Gas Works	36%

Source: Foster Associates, Inc.

There are also regional variations of entitlements, (Table 5), with the gas distributors of the Central region having a relatively larger porportion of the less expensive Block 1 gas than those in the East or West.

Table 5

ESTIMATED ENTITLEMENT OF BLOCK 1 GAS SUPPLY
AS A PERCENT OF REGIONAL SUPPLY REQUIREMENTS*

East	40-50%
Central	50-60%
West	25-35%

* Excludes the Southwest intrastate market.

Source: Regions based on pipeline groupings in Schedule 5 of the Statistical Appendix.

These variations in the relative importance of Block 1 gas for the different distributors across the country could result in further market distortion, as well as direct economic benefits to those distributors and regions that fortuitously have a higher relative allotment of Block 1 gas. Two major benefits include (1) the ability to outbid others for gas supplies, and (2) the economic advantage to industry in markets served by distributors with more Block 1 gas.

Implementing block billing will not level the playing field unless or until there is not only substantial evening out of Block 1 gas prices and volume, but also evening out of Block 2 gas prices, which means major declines in Block 2 pricing. Furthermore, the implementation of block billing will put a substantial strain on many U.S. interstate gas pipelines in that they will not be able to compete in the Block 2 gas market because of their relatively high cost gas sources. These pipelines have contracted for much of this gas under the long term policy of rolled-in pricing such that their average gas cost would stay at a competitive level. If all of a sudden the rules change, as under the block billing proposal, it would be grossly unfair to these pipelines, their customers, as well as their suppliers.

The block billing program will reduce Block 2 gas prices. In the first place, there will be substantial competition among Block 2 suppliers to the same market. Also, Block 2 gas will not be able to incrementally compete with direct gas purchases (by distribuors) or with No. 6 fuel oil.

A comparison for 12 selected cities has been made of city gate Block 2 prices with (1) direct gas purchase prices of distributors and (2) No. 6 fuel oil prices measured at the city gate. The results of this comparison are shown on Schedule 6 of the Statistical Appendix. City gate Block 2 prices are shown for each major pipeline delivering to the city. Direct gas purchases are calculated as current field prices (about $2.60 per MMBtu)[1] plus transportation costs to the city gate. And, the No. 6 fuel oil prices are retail prices, as of Fall 1985, minus the interruptible industrial gas distribution margin.

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[1] The direct purchase price could be as low as $2.00 per MMBtu (in the field) putting even greater pressure on high cost Block 2 gas supplies.

prices, as of Fall 1985, minus the interruptible industrial gas distribution margin.

The differential between each city's average Block 2 price and (1) least cost Block 2 price, (2) the direct purchase price and (3) the No. 6 fuel price provides estimates of the degree to which Block 2 gas prices will fall if block billing were to be implemented. And, as discussed later, this undue reduction in gas prices will have an impact on U.S. exploration and development efforts.

Table 6 (below) shows the reduction in Block 2 prices required for Block 2 gas to be competitive in selected cities. Simple and weighted averages are shown by region and for the total U.S. For the U.S. as a whole, the price reduction ranges from a low of $.39 per MMBtu to a high of almost $1.00 per MMBtu. (If we had used a low spot gas price of $2.00 per MMBtu field price as an alternative direct gas purchase price, then the range is $.39 to about $2.00 per MMBtu.) This price reduction will affect reserves available to the industry, and curtail exploration and development efforts, as discussed below.

Table 6

REDUCTION IN BLOCK 2 GAS PRICES REQUIRED TO BE COMPETITIVE
($ per MMBtu)

	Average Block 2 Price Relative to:		
	Lowest Block 2	Direct Purchase	No. 6 Fuel Oil
EAST			
New York	.40	.82	.76
Philadelphia	.25	.68	(.33)
Baltimore	N/A	1.24	.91
Atlanta	.75	1.45	.59
Simple Avg.	.46	1.05	.48
Weighted Avg.	.46	.98	.58
CENTRAL			
Chicago	.47	.53	.14
Detroit	.73	.91	.91
Minneapolis	N/A	2.13	1.18
St. Louis	N/A	N/A	(.20)
Cleveland	.15	.95	.16
Simple Avg.	.45	1.13	.41
Weighted Avg.	.49	1.00	.49
WEST			
Los Angeles	.06	.65	.28
San Francisco	.30	.50	.10
Seattle	N/A	.95	.67
Simple Avg.	.18	.70	.35
Weighted Avg.	.17	.62	.25
U.S. TOTAL			
Simple Avg.	.39	.98	.43
Weighted Avg.	.38	.88	.45

NOTE: Weighted average based on relative gas sales in each city.

Source: Schedule 6 of the Statistical Appendix.

III. PROSPECTIVE IMPACTS OF BLOCK BILLING ON U.S. GAS MARKETS

A. Base Case (NGPA Rolled-in Prices)

The long term impact of block billing on the U.S. gas industry depends on the prospective trends in gas supply, demand and price. As stated above, there is currently a deliverability surplus of between 3 and 4 Tcf of gas on an annual basis, or just over 20 percent of total requirements. This surplus is expected to be worked off over time as demand increases and existing gas reserves are depleted. Also contributing to the decline in the surplus is the expectation of lower U.S. reserves additions over the next five years, estimated at just over an average of 13 Tcf per year. This relatively low projection of reserves additions is a direct result of lower new contract prices and the gas deliverability surplus itself. Table 7 sets out projected U.S. gas supply and demand balance over the period 1985 to 1990.[1] (Also shown are historical data from 1980.) Schedule 7 of the Statistical Appendix sets out further detail with respect to U.S. gas supply and price projections under this base case. Schedule 7 actually shows two cases reflecting different patterns of high cost gas prices and takes. These cases are reflected below as ranges on Tables 7 and 8.

Projected demand is shown to increase slowly from 18.1 Tcf to just over 19.0 Tcf by 1990. Average Lower 48 States gas supply availability stays fairly constant until about 1987 at 20 Tcf per year, then begins to decline to 17.6 Tcf by 1990. The decline reflects the impact of the lower reserves additions over this period, as well as continued depletion of existing gas reserves.

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[1] Rolled-in pricing of gas to establish a rate making policy is assumed under this forecast.

Table 7

PROJECTED U.S. GAS SUPPLY/DEMAND BALANCE (TCF)

Year	Available Supply			Takes		
	Lower 48 (Base Case)	Canadian Authorized Potential		Lower 48	Canadian[a/]	Demand[b/]
1980	19.9	1.2		19.4	0.9	20.5
1981	20.6	1.4		19.2	0.8	19.9
1982	20.8	1.8		17.8	0.9	18.4
1983	19.9	1.8		16.0	0.9	17.3
1984	20.1	1.7		17.3	0.8	18.1
		U.S./ Can. App.	Can. App.			
1985	20.4	1.7	0.5	17.2	0.9	18.1
1986	20.2	1.5	0.7	17.2-17.4	1.0	18.2-18.4
1987	20.1	1.0	0.9	17.4-17.6	1.1	18.5-18.7
1988	19.1	0.8	1.2	17.6-17.8	1.1	18.7-18.9
1989	18.3	0.6	1.3	17.6-17.8	1.2	18.8-19.0
1990	17.6	0.2	1.5	17.4-17.6	1.6	19.0-19.2

a/ Authorized plus potential for projected years.
b/ Historical and projected figures include 0.5 Tcf/yr of "unaccounted for" gas.

Source: Deregulation and Competition for U.S. Natural Gas Markets, 1985-2000, Foster Associates, Inc.

Any regulatory program that might result in lower prospective reserves additions could jeopardize the U.S. supply/demand balance that is projected towards the end of the 1980s. For example, by 1990 between 40 and 50 percent of U.S. production capacity will come from new reserves, found and developed between 1985 and 1990.

Available Canadian gas shown on Table 7 reflects two potential volumes. One estimate includes only projects that have U.S. and Canadian import/export approval and the other currently only has Canadian export authorization and is awaiting U.S. approval.

The underlying price projections of this supply/demand balance forecast are set out in Table 8 for old gas, high cost gas under contract, new contracts, intrastate gas and Canadian imports. Old gas is assumed to remain under price controls at the current NGPA price ceiling. High cost gas under interstate contracts is shown in a range because of the uncertainty of the price of gas to be purchased under non-market sensitive contracts. Currently, these supplies represent about 50 percent of the total high cost gas, at an average price of $4.11 per MMBtu. The low end of the range for this gas assumes that the average price will equate to the new contract market price by 1990. The upper price of the range assumes that the this price will track world oil prices, which are shown on Schedule 8 of the Statistical Appendix.

Table 8

PROJECTED U.S. NATURAL GAS FIELD PRICES
(Current $/MMBtu)

Year	Old Gas[a/]	New Gas Under Contract	New Contract Market Price	Intrastate Gas Price[b/]	Average U. S. Field Price	Canadian Imports
1985	1.46	3.43	2.60	2.56	2.53	3.20
1986	1.52	3.13-3.43	2.40	2.50	2.44-2.53	2.80
1987	1.59	3.09-3.36	2.39	2.55	2.46-2.56	2.59
1988	1.65	2.94-3.29	2.55	2.60	2.49-2.60	2.60
1989	1.73	2.95-3.29	2.77	2.77	2.65-2.73	2.77
1990	1.80	2.95-3.36	2.95	2.95	2.80-2.88	2.95

a/ Interstate gas market.
b/ Includes small quantities of "other".

Source: Schedule 7 of the Statistical Appendix.

The new contract price in 1985 is the current average price of interstate purchases with contracts executed in that year. This price is projected to trend with oil prices until about 1988 and then show somewhat higher increases than oil prices to 1990, reflecting the general tightening of U.S. gas markets expected near the end of the decade.

B. Block Billing Case

The projections described above reflect continuing rolled-in pricing policies for rate making purposes. Analysis of the sensitivity of this forecast to the block billing proposal was conducted to determine the potential impact on supply, demand and price of U.S. markets. An alternative rolled-in case was also analyzed to determine the impact of increasing old gas prices to "just and reasonable" levels. In contrast to the impact of block billing, which is expected to have a downward effect on the U.S. reserves position, it has been found that increasing old gas prices should have a positive impact on U.S. gas supplies.

As discussed above, if block billing were to be implemented, then Block 2 gas prices would have to come down in order for this gas to be competitive. It has already been established that a decline of about $0.40 to $1.00 per MMBtu would be necessary under current market conditions (see Table 6). Because of the uncertainty of this reduction in the future, a range of projected Block 2 prices has been used to reflect implementation of block billing, as shown as Cases A and B on Schedule 9 of the Statistical Appendix. Case A of Schedule 9 assumes a decline in existing Block 2 gas prices to the level of new contract prices by 1989. Here the current price of $3.43 per MMBtu falls to $2.61 per MMBtu by 1987 ($0.22 per MMBtu above new contract prices for that year), and [illegible] increases [illegible] $2.95 per MMBtu [illegible] -- the new contract price.[1]

Case B of Schedule 9 shows existing Block 2 gas falling to new contract prices by 1988. In addition, the lower end of the range also assumes that new contract prices fall slightly, as pipelines bid down new contract prices in order to keep their average Block 2 gas prices at a competitive level. This assumes that distributors and/or end-users are not able to directly purchase their own supplies and have them transported. Intrastate gas prices are also driven down to new contract prices by 1988.

Under block billing, old gas volumes increase slightly over the rolled-in case volumes because of greater demand for old gas in the market. This is not a situation in which the overall reserves of old gas increase; however, it is where old gas supplies are produced at a faster rate because of a greater demand in the short run (e.g., if Block 1 gas is not taken, then it may be lost to others.) This increase is offset by declines of takes for the existing high cost Block 2 gas. In addition, there is an increase in overall U.S. gas demand as a result of lower overall gas prices. This increase averages about 2 percent per year over the 1986 - 1990 period.

It is projected that block billing will result in lower producer revenues in spite of the slightly higher level of gas production (i.e., higher U.S. demand). This lower revenue is calculated as the difference between revenues under the rolled-in case and the block billing case. It ranges between $5 billion to $17 billion over the 1986 - 1990 period, as shown below. The low end of the revenue reduction range reflects the difference between the low base case (Schedule 7) and Block Billing Case (A) (Schedule 9). The upper end of the revenue reduction range reflects the difference between the revenues of the high base case and Block Billing Case (B).

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[1] The new contract price is above the spot market price, estimated at $2.00 MMBtu over the 1985 to 1986 period. Spot prices may have the tendency to increase over time after the implementation of block billing, as more and more distributors and end-users enter the spot market to bypass Block 2 gas costs and as supplies tighten.

Table 9

REDUCED PRODUCER REVENUES
AS A RESULT OF BLOCK BILLING
(Billions of Dollars)

Year	Reduction in Revenues
1986	1.5 - 3.2
1987	1.9 - 4.4
1988	1.2 - 5.6
1989	.5 - 2.9
1990	.2 - 1.0
TOTAL	5.3 -17.1

Source: Foster Associates, Inc.

To reduce revenues to producers through block billing, as well as undermining the confidence of investors involved in exploration and development efforts, will have an adverse long-term effect on U.S. natural gas reserves. It is impossible to determine the psychological impact of implementing such a program on investors' confidence, however, one can directly convert the potentially lost revenues to reduced exploration and development efforts based on historical experiences in the industry.

Estimated 1985 drilling costs are expected to be below the 1978-1982 average, and furthermore, these costs are not expected to increase over the prospective period because of declining oil and gas prices. To the extent that drilling costs remain at these low levels, compared to the historical period, the impact on reserves as a result of block billing has to be considered as conservative.

Almost 60 percent of the high cost gas without market sensitive pricing is currently being produced by non-major producers (i.e., non-majors rank 16th and below in total production volumes). Therefore, any program resulting in a substantial reduction in high cost gas prices will materially impact small independent producers who conduct much of the U.S. exploratory effort.

In the past, exploration and development expenditures by the petroleum industry have represented about 55 percent of total oil and gas sales revenues.[1] Furthermore, it is estimated that the unit cost of finding and developing one Mcf of gas is about $1.63 per Mcf, excluding production costs, operating expenses, taxes, and return to investors. This estimate is based on exploration and development expenditures over the 1978-1982 period as reported by the U.S. Department of Commerce, of which 52 percent was estimated to reflect exploration and development for natural gas.[2,3]

Using the $1.63 per Mcf as the cost of finding and exploring for gas and the $5 to $17 billion of reduced revenues (reduced by 45 percent to reflect only dollars spent on exploration and development), the lost reserves total 2 Tcf to 6 Tcf over the 1986-1990 period, and a reduced annual production capacity of 200 Bcf to 500 Bcf by 1990 (based on an 8 year reserves/production ratio constraint), as summarized below.

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[1] Other dispositions of funds were to production expenses, interest, taxes and other operating and administrative expenses as well as returns to investors. Source of these data is the Annual Survey of Oil and Gas, 1982, published by U.S. Department of Commerce. Estimate reflects data for 1978 - 1982.

[2] Fifty-two percent of total successful well costs were for gas drillings, assumed to be applied to total exploration and development effort. Total exploration and development expenditures for gas divided by total nonassociated reserves additions (excluding revisions) over the same period yields the $1.63 per Mcf.

[3] The current average drilling cost in the U.S. is approximately the same as 1978-1982 level.

Table 10

U.S. DOMESTIC SUPPLY IMPACT
AS A RESULT OF BLOCK BILLING

	1986	1987	1988	1989	1990
Reduced Reserves (Bcf)	508-1066	634-1486	420-1896	152-968	59-340
Reduced Productive Capacity[a/] (Bcf/yr)	--	56- 174	167-566	165-535	160-513

a/ Estimated based on 8 year reserves-to-production constraint.

Source: Foster Associates, Inc.

C. Increasing Old Gas Prices as the Better Solution

The potentially adverse supply impact of block billing is in contrast to the positive impact for the case of increasing old gas prices to "just and reasonable" levels. Under this alternative case, it has been assumed that the price of old cheaper gas is increased to the new contract market price by 1990. Average U.S. prices have been held constant at the rolled-in level (Base Case); therefore declines in high cost gas under contract offset the old gas price increase. Under this case, U.S. gas demand remains the same as under the rolled-in case. Table 11 sets out the projected prices and domestic gas volumes for this case.

Table 11

PROJECTED U.S. GAS PRICES UNDER ROLLED-IN PRICING AND INCREASED OLD GAS PRICES TO "JUST AND REASONABLE" LEVELS[a]

	OLD		HIGH COST GAS UNDER CONTRACT		NEW CONTRACT GAS[b]		EXISTING INTRASTATE[c]		TOTAL[d]	
YEAR	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME
	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf
1985	$1.46	4.2	$3.43	4.7	$2.60	-	$2.56	8.3	$2.53	17.2
1986	1.72	4.2	3.35	3.6	2.40	1.3	2.50	8.2	2.48	17.3
1987	1.99	3.6	3.20	2.8	2.39	3.2	2.55	7.9	2.51	17.5
1988	2.25	3.2	2.71	2.9	2.55	5.5	2.60	6.1	2.54	17.7
1989	2.52	2.8	2.66	2.6	2.73	7.5	2.73	4.8	2.69	17.7
1990	2.84	2.5	2.84	2.2	2.84	9.2	2.84	3.6	2.84	17.5

a/ Prices are expressed in current dollars.
b/ Purchases from new (post '84) reserves additions for both interstate and intrastate markets.
c/ Includes small quantity of other.
d/ Reflects midpoint of Base Case range.

Source: Foster Associates, Inc.

Under this case, old gas prices are increased to the average market price by 1990, i.e., to $2.84 per MMBtu, a 57 percent increase over the price controlled level. In 1990, new gas prices are 4 percent lower under this case as compared to the rolled-in base case to offset the higher old gas prices.

One could expect a more certain long-term supply response resulting from the increase in old gas prices (i.e., more recoverable reserves) than the short-term (smaller) negative response resulting from slightly lower new gas prices (e.g.

greater knowledge exists with respect to the remaining unrecoverable old gas reserves that might be available by the new exploration efforts).

It is probable that an increase of 57 percent in old gas prices would have a substantial long-term impact on increasing gas reserves. It would surely delay abandonment of non-economic wells, i..e, at the higher price level, the total revenues will exceed costs for a longer period of time and production will not be abandoned. In addition, higher old gas prices will justify the investments in well stimulation techniques that can prove up additional reserves.

Over the last couple of years, two studies have become available setting out estimates of new reserves as a result of increased old gas prices. In April 1983, Dr. C. S. Mathews of Shell Oil published his paper Increase in United States 'Old Gas' Reserves Due to Deregulation. And in February 1984, the U.S. Congress Office of Technology Assessment published a Staff Memorandum on the Effects of Decontrol on Old Gas Recovery (OTA report), which is a review of the Shell report.

A comparative summary of results of the two studies is shown on Table 12.

Table 12

OLD GAS RESERVE ADDITIONS
(Tcf)

	SHELL			OTA		
	NGPA	Full Decontrol (Incremental Effect)	Total	NGPA	Full Decontrol (Incremental Effect)	Total
Delayed Abandonment	neg.	27	27	5-13	7-20	12-31
Infill Drilling	3	18	21	13-20	7-14	25-28
Well Stimulation	neg.	7	7	2	4	6
Total, All Sources	3	52	55	20-35	19-38	43-65

Shell's incremental reserves additions resulting from increased old gas prices total 52 Tcf, compared with 19 to 38 Tcf for OTA.

There are, of course, many uncertainties as to the impact of increasing old gas prices to a decontrol level, or simply deregulating them. These uncertainties include the level of "just and reasonable" prices and the timing of potential new reserves additions. One thing is clear, however, substantial reserves would be forthcoming by increasing old gas prices; therefore to increase old gas prices to "just and reasonable" levels to deal with the remaining cushion gas problem would have the added advantage of greater reserves additions (as well as getting directly to the root of the problem) where block billing would have the opposite effect.

IV. CONCLUSION

This study analyzes block billing and its intended purposes. It is concluded that the market forces operating within the U.S. natural gas industry provide a superior means of correcting the remaining gas market problems. These problems have been created by over-regulation of the industry in the past; to create a whole new ad hoc regulatory scheme, such as block billing, to resolve these problems is counter-productive and may create additional adverse effects. Greater benefits to the industry and consumers will be realized if the prices of old gas are allowed to achieve "just and reasonable" levels which will, in turn, help bring on new reserves necessary to replenish domestic gas supplies.

STATISTICAL APPENDIX

Schedule 1

COMPOSITE OF PROJECTED GAS PURCHASES AND AVERAGE COSTS BY NGPA CATEGORY PGA DATA IN EFFECT AS OF 11/1/85 FOR 30 PIPELINES a/

NGPA Category b/ (1)	Volume (000 MMBtu) (2)	Percent of Total Field Purchases (3)	Average Cost ($/MMBtu) (4)
Controlled Gas			
102 New Gas from Old OCS Leases	1,001,903	11.18%	$3.71
103 Wells Less Than 5,000 Ft. Deep	398,395	4.45	3.16
Other 103	10,865	0.12	3.07
TOTAL 103	409,260	4.57	3.16
104 Pre 1973 Wells	1,067,855	11.92	0.60
1973-1974 Wells	295,889	3.30	1.78
Post 1974 Wells	1,275,904	14.24	2.56
Pre 1973 Repl./Recomp.	608,175	6.79	1.04
Other 104	60,159	0.67	1.05
TOTAL 104	3,307,982	36.92	1.55
106 Interstate Rollovers	357,894	3.99	1.03
Contract Rate and Minimum Rate Gas	360,845	4.03	0.46
Volumes Not Identifiable By NGPA Category	226,338	2.53	2.93
TOTAL CONTROLLED GAS	5,664,222	63.22	2.00
Decontrolled Gas			
102 New Gas	1,640,058	18.30	3.24
103 Wells Greater Than 5,000 Ft. Deep	505,014	5.64	3.06
107 Tight Sands	170,375	1.90	3.54
Deep Gas	431,829	4.82	4.44
Other 107	58,532	0.65	3.70
TOTAL 107	660,737	7.37	4.14
TOTAL DECONTROLLED GAS	2,805,805	31.31	3.42
Miscellaneous Gas			
105 Intrastate	62,197	0.69	2.01
106 Intrastate Rollovers	14,761	0.16	2.52
108 Stripper Wells	209,232	2.33	3.80
109 Other	204,520	2.28	2.58
TOTAL MISCELLANEOUS GAS	490,710	5.47	3.03
TOTAL FIELD PURCHASES	8,960,738	100.00	2.50
TOTAL IMPORTS	985,522		3.12
TOTAL PURCHASES b/	9,946,260		2.56

a/ For Columbia Gas Transmission Corp. and Trunkline Gas Co., the volumes and average prices are those in effect as of 3/01/85 and 9/01/84, respectively. Includes Tennessee's proposed WACOG of $2.38 submitted to the FERC on 10/15/85.

b/ Totals exclude inter-pipeline transactions.

Source: Current Purchased Gas Costs of Interstate Pipeline Companies, published by Foster Associates, Inc.

Schedule 2

ESTIMATED SURPLUS OF NATURAL GAS
(Bcf)

Date Surveyed	Estimated Surplus Volume[a/]
1981	
January	219
April	437
July	410
October	242
1982	
January	456
April	864
July	1,229
October	1,189
1983	
January	1,715
April	2,605
July	2,357
October	2,077
1984	
January	1,695
April	1,897
July	1,872
October	1,506
1985	
January	1,650
April	1,896
July	1,752

a/ Volume estimated as available during six month period beginning with survey month.

Source: U.S. Department of Energy, Energy Information Administration, Natural Gas Monthly.

Schedule 3

ESTIMATED GAS DELIVERABILITY AND SURPLUS PRODUCTION CAPACITY TOTAL U.S.

Year	Production (Tcf)	Estimated Deliverability (Tcf)	Estimated Surplus
1979	19.7	19.7	---
1980	19.4	19.9	0.5
1981	19.2	20.6	1.4
1982	17.8	20.8	3.0
1983	16.0	19.9	3.9
1984	17.3	20.1	2.9
1985*	17.1	20.0	2.9

*Projected

Source: American Gas Association, "1985 Outlook", Gas Energy Review.

Schedule 4

NATURAL GAS SUPPLY STATISTICS FOR THE LOWER 48 STATES

Year	Reserves Additions (Tcf)	Production (Tcf)	Proved Reserves (Tcf)	Reserves to Production Ratio	Finding-to Production Ratio
1960	13.8	12.2	262.2	21.5	1.13
1961	16.4	12.6	265.4	21.1	1.30
1962	18.9	13.2	270.6	20.5	1.43
1963	18.1	14.0	274.5	19.6	1.29
1964	20.1	14.7	279.4	19.0	1.37
1965	21.2	15.3	284.5	18.6	1.39
1966	19.2	16.5	286.4	17.4	1.16
1967	21.1	17.4	289.3	16.6	1.21
1968	12.0	18.4	282.1	15.3	0.65
1969	8.3	19.8	269.9	13.6	0.42
1970	11.1	20.9	259.6	12.4	0.53
1971	9.4	21.4	247.4	11.6	0.44
1972	9.4	21.5	234.6	10.9	0.44
1973	6.5	21.6	218.3	10.1	0.30
1974	8.3	20.6	205.3	10.0	0.40
1975	10.1	19.1	196.2	10.3	0.53
1976	7.4	18.9	184.1	9.7	0.39
1977	13.0	19.0	175.2	9.2	0.68
1978	19.4	18.9	176.0	9.3	1.03
1979	11.8	19.4	168.7	8.7	0.61
1980	15.4	19.2	165.6	8.6	0.80
1981	21.6	18.9	168.7	8.9	1.14
1982	15.1	17.5	166.5	9.5	0.86
1983	15.0	15.8	166.0	10.5	0.95
1984	13.9	16.9	163.0	9.6	0.82

Note: Reserves and reserves additions data for 1960-1976 are from AGA; thereafter EIA data are used. Production data for all years are for dry marketed production as reported by the EIA.

Source: American Gas Association and Energy Information Administration.

Schedule 5

AVERAGE BLOCK GAS COSTS OF INTERSTATE PIPELINES

Region/Pipeline	Pipeline Inlet			City Gate a/		
	Block 1 Cost	Block 2 Cost	WACOG	Block 1 Plus Transmission Cost	Block 2 Plus Transmission Cost	WACOG Plus Transmission
EAST						
Columbia Gas Transmission	$1.87	$3.74	$3.53	$2.72	$4.59	$4.38
Consolidated Gas Trans.	$1.91	$3.66	$3.45	$2.09	$3.84	$3.63
Florida Gas Transmission	$1.54	$3.19	$2.60	$2.17	$3.82	$3.23
National Fuel Gas	NA	NA	$3.46	NA	NA	$3.85
Southern Natural Gas	$1.54	$4.02	$2.86	$2.33	$4.81	$3.65
Tennessee Gas P.L.	$1.70	$3.87	$2.38	$2.25	$4.42	$2.93
Texas Eastern Transmission	$1.25	$3.07	$2.46	$2.02	$3.84	$3.23
Transcontinental Gas P.L.	$1.92	$3.60	$3.04	$2.91	$4.59	$4.03
CENTRAL						
ANR Pipeline	$1.58	$3.72	$2.62	$3.08	$5.22	$4.12
ARKLA	$1.48	$2.79	$2.49	$2.22	$3.53	$3.23
Great Lakes Gas Transmission	—	$3.49	$3.49	—	$3.65	$3.65
Midwestern (Northern System)	—	$3.48	$3.48	—	$3.59	$3.59
Mississippi River Trans.	$2.38	$3.17	$3.08	$2.85	$3.64	$3.55
Natural Gas P.L. Co. of Am.	$1.59	$3.31	$2.47	$2.11	$3.83	$2.99
Northern Natural Gas	$1.03	$3.72	$2.40	$2.11	$4.80	$3.48
Northwest Central P.L.	$1.03	$3.58	$1.97	$1.80	$4.35	$2.74
Panhandle Eastern P.L.	$1.64	$3.46	$2.39	$2.71	$4.53	$3.46
Texas Gas Transmission	$1.84	$3.61	$2.86	$2.38	$4.15	$3.40
Trunkline Gas	$2.00	$4.36	$2.57	$2.83	$5.19	$3.40
United Gas Pipe Line	$1.81	$3.03	$2.53	$2.89	$4.11	$3.61
WEST						
Colorado Interstate Gas	$0.96	$3.01	$2.14	$2.13	$4.18	$3.31
El Paso Natural Gas	$1.34	$3.20	$2.46	$2.54	$4.40	$3.66
Northwest Pipeline	$1.32	$3.13	$2.72	$2.00	$3.81	$3.40
Pacific Gas Transmission	—	$3.15	$3.15	—	$3.45	$3.45
Pacific Interstate Trans.	—	$2.85	$2.85	—	$4.27	$4.27
Transwestern P.L.	$1.33	$3.20	$2.60	$1.94	$3.81	$3.21

a/ Equals pipeline gas cost plus system average transmission cost.

Source: Current Purchased Gas Costs of Interstate Pipeline Companies, published by Foster Associates, Inc. and FERC Form II filings by the pipelines.

Sheet 1 of 3

Schedule 6

COMPARISON OF ESTIMATED BLOCK 2 GAS PRICES WITH DIRECT PURCHASES AND NO. 6 FUEL OIL PRICES

(Fall 1985)

		City-Gate ($/MMBtu)
EAST		
New York	Transcontinental Gas Pipe Line	$ 4.30
	Texas Eastern Transmission Corp.	$ 3.82
	Tennessee Gas Pipeline Corp.	$ 4.65
	Weighted Average	$ 4.22
	Direct Purchase	$ 3.40
	No. 6 Netback	$ 3.46
Philadelphia		
	Texas Eastern Transmission Corp.	$ 3.83
	Transcontinental Gas Pipe Line.	$ 4.34
	Weighted Average	$ 4.06
	Direct Purchase	$ 3.40
	No. 6 Netback	$ 4.41
Baltimore		
	Columbia Gas Transmission Corp.	$ 4.69
	Direct Purchase	$ 3.45
	No. 6 Netback	$ 3.78
Atlanta		
	Southern Natural Gas Co.	$ 5.06
	Transcontinental Gas Pipe Line	$ 4.20
	Weighted Average	$ 4.95
	Direct Purchase	$ 3.50
	No. 6 Netback	$ 4.36

Sheet 2 of 3

Schedule 6

COMPARISON OF ESTIMATED BLOCK 2 GAS PRICES WITH DIRECT PURCHASES AND NO. 6 FUEL OIL PRICES (Fall 1985)

		City-Gate ($/MMBtu)
CENTRAL		
Chicago	Natural Gas Pipeline Co.	$ 4.12
	Midwestern Gas Transmission	$ 3.56
	Weighted Average	$ 4.03
	Direct Purchase	$ 3.50
	No. 6 Netback	$ 3.89
Detroit	ANR Pipeline Co.	$ 5.09
	Great Lakes Gas Transmission	$ 4.31
	Panhandle Eastern Pipe Line	$ 4.89
	Weighted Average	$ 5.04
	Direct Purchase	$ 3.10
	No. 6 Netback	$ 4.13
Minneapolis		
	Northern Natural Gas	$ 5.23
	Direct Purchase	$ 3.10
	No. 6 Netback	$ 4.05
St. Louis		
	Mississippi River Transmission	$ 3.92
	Direct Purchase	N/A
	No. 6 Netback	$ 4.12
Cleveland		
	Consolidated Gas Transmission	$ 3.90
	Panhandle Eastern Pipe Line	$ 4.71
	Weighted Average	$ 4.05
	Direct Purchase	$ 3.10
	No. 6 Netback	$ 3.69

Sheet 3 of 3

Schedule 6

COMPARISON OF ESTIMATED BLOCK 2 GAS PRICES WITH DIRECT PURCHASES AND NO. 6 FUEL OIL PRICES (Fall 1985)

		City-Gate ($/MMBtu)
WEST		
Los Angeles		
	El Paso Natural Gas	$ 3.79
	Transwestern Pipeline	$ 3.82
	Pacific Lighting[a/]	$ 4.29
	Weighted Average	$ 3.85
	Direct Purchase	$ 3.20
	No. 6 Netback	$ 3.57
San Francisco		
	El Paso Natural Gas	$ 3.79
	Pacific Gas Transmission[a/]	$ 3.40
	Weighted Average	$ 3.70
	Direct Purchase	$ 3.20
	No. 6 Netback	$ 3.60
Seattle	Northwest Pipeline	$ 3.95
	Direct Purchase	$ 3.00
	No. 6 Netback	$ 3.28

a/ Canadian supplies.

Source: Foster Associates, Inc.

Schedule 7

PROJECTED U.S. GAS VOLUMES AND PRICES UNDER ROLLED-IN PRICING (BASE CASE)a/

ROLLED-IN CASE (A)

YEAR	OLD		HIGH COST GAS UNDER CONTRACT		NEW CONTRACT GASb/		EXISTING INTRASTATEc/		TOTAL	
	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME
	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf
1985	$1.46	4.2	$3.43	4.7	$2.60	-	$2.56	8.3	$2.53	17.2
1986	1.52	3.7	3.13	4.2	2.40	1.3	2.50	8.2	2.44	17.4
1987	1.59	3.3	3.09	3.8	2.39	2.6	2.55	7.9	2.46	17.6
1988	1.65	2.9	2.94	3.3	2.55	5.5	2.60	6.1	2.49	17.8
1989	1.73	2.6	2.95	2.9	2.77	7.5	2.77	4.8	2.65	17.8
1990	1.80	2.3	2.95	2.5	2.95	9.2	2.95	3.6	2.80	17.6

ROLLED-IN CASE (B)

YEAR	OLD		HIGH COST GAS UNDER CONTRACT		NEW CONTRACT GASb/		EXISTING INTRASTATEc/		TOTAL	
	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME	PRICE	VOLUME
	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf
1985	$1.46	4.2	$3.43	4.7	$2.60	-	$2.56	8.3	$2.53	17.2
1986	1.52	3.7	3.43	4.5	2.40	0.8	2.50	8.2	2.53	17.2
1987	1.59	3.3	3.36	4.4	2.39	1.8	2.55	7.9	2.56	17.4
1988	1.65	2.9	3.29	4.3	2.55	4.3	2.60	6.1	2.60	17.6
1989	1.73	2.6	3.29	3.9	2.77	6.3	2.77	4.8	2.73	17.6
1990	1.80	2.3	3.36	3.5	2.95	8.0	2.95	3.6	2.88	17.4

a/ Prices are expressed in current dollars.
b/ Purchases from new (post '84) reserve additions for both interstate and intrastate markets.
c/ Includes small quantity of other.

Source: Foster Associates, Inc.

Schedule 8

HISTORICAL AND PROJECTED CRUDE OIL PRICES AVERAGE U.S. REFINERIES ACQUISITION COST

Year	Current Dollars per Barrel
1972	$ 3.58
1973	4.15
1974	9.07
1975	10.38
1976	10.89
1977	11.96
1978	12.46
1979	17.72
1980	28.07
1981	35.24
1982	31.87
1983	28.99
1984	28.63
1985	26.00
1986	26.00
1987	25.50
1988	25.00
1989	25.00
1990	25.50

Source: Historical data from Energy Information Administration, Monthly Energy Review. Projections by Foster Associates.

Schedule 9

NATURAL GAS SUPPLY AND PRICES UNDER BLOCK BILLING[a]

BLOCK BILLING CASE (A)

YEAR	BLOCK 1 PRICE	BLOCK 1 VOLUME	BLOCK 2 EXISTING PRICE	BLOCK 2 EXISTING VOLUME	NEW CONTRACT b/ GAS PRICE	NEW CONTRACT b/ GAS VOLUME	EXISTING c/ INTRASTATE PRICE	EXISTING c/ INTRASTATE VOLUME	TOTAL PRICE	TOTAL VOLUME
	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf
1985	$1.46	4.2	$3.43	4.7	$2.60	-	$2.56	8.3	$2.53	17.2
1986	1.52	4.2	2.87	3.7	2.40	1.4	2.50	8.2	2.34	17.5
1987	1.59	3.6	2.61	3.4	2.39	2.8	2.55	7.9	2.34	17.7
1988	1.65	3.2	2.66	2.9	2.55	5.6	2.60	6.1	2.42	17.8
1989	1.73	2.8	2.77	2.7	2.77	7.6	2.77	4.8	2.61	17.9
1990	1.80	2.5	2.95	2.3	2.95	9.2	2.95	3.6	2.79	17.6

BLOCK BILLING CASE (B)

YEAR	BLOCK 1 PRICE	BLOCK 1 VOLUME	BLOCK 2 EXISTING PRICE	BLOCK 2 EXISTING VOLUME	NEW CONTRACT b/ GAS PRICE	NEW CONTRACT b/ GAS VOLUME	EXISTING c/ INTRASTATE PRICE	EXISTING c/ INTRASTATE VOLUME	TOTAL PRICE	TOTAL VOLUME
	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf	$/MMBtu	Tcf
1985	$1.46	4.2	$3.43	4.7	$2.60	-	$2.56	8.3	$2.53	17.2
1986	1.52	4.2	2.70	3.8	2.20	1.5	2.50	8.2	2.28	17.7
1987	1.59	3.6	2.55	3.6	2.19	2.9	2.40	7.9	2.23	18.0
1988	1.65	3.2	2.35	3.1	2.35	5.6	2.35	6.1	2.23	18.0
1989	1.73	2.8	2.65	2.8	2.65	7.6	2.65	4.8	2.51	18.0
1990	1.80	2.5	2.95	2.3	2.95	9.2	2.95	3.6	2.79	17.6

a/ Prices are expressed as current dollars.
b/ Purchases from new (post '84) reserve additions for both interstate and intrastate markets.
c/ Includes small quantity of other.

Source: Foster Associates, Inc.

APPENDIX B

THE GAS SUPPLY EFFECTS OF THE FERC "BLOCK BILLING" PROPOSAL

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November 11, 1985

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The comments in this paper are designed to respond to the Federal Energy Regulatory Commission economic analysis of the effects of block billing on the long run supply and price of natural gas (as contained in the text of the FERC Notice Requesting Supplemental Comments, Issued October 9, 1985, and in Exhibit S, "An Economic Analysis of Supply Adequacy in the Natural Gas Industry," Docket No. RM85-1-000 Part D) and to address the Commission's economic rationale for the block billing proposal. (Note that references below to page numbers that begin with single numbers refer to the block billing Notice. Single numbers that begin with S refer to Exhibit S.)

I conclude below that the Staff economic "model" does not provide an adequate theoretical or even descriptive basis on which to study the supply effects of block billing under the current conditions in the gas industry. This "model" ignores or assumes away the basic economics surrounding the incentives to explore for and develop new gas reserves -- the most important determinant of long run gas supplies and prices. It ignores or treats as costless the downstream inefficiencies which block billing would either perpetuate or promote.

Furthermore the FERC's economic justification for the block billing proposal seems to rest on a series of misconceptions regarding the relationship of regulated old gas prices and so-called "rolled-in" pricing in creating the market distortions now pervading the gas industry.

Without the elimination of the ceiling prices on "old" gas and other contract rigidities, the market distortions cited by the FERC in its justification cannot be eliminated no matter how natural gas is "billed" or where in the chain of distribution entitlements are granted. The FERC's block billing proposal is, at a minimum, unjustified and internally inconsistent and, at a maximum, is harmful to the long-term interests of natural gas consumers in obtaining assured gas supplies at least cost.

I. Basic Economics of Gas Supply Incentives

Resource economists have long recognized that the "exhaustible" nature of oil and gas supplies imposes certain conditions on the economics of their production which differ in fundamental ways from those of other commodities.[1] In addition to labor and capital, there is a "user cost" to the depletion of oil and gas reserves which, roughly speaking, corresponds to the opportunity cost of depleting the reserves today rather than later. This "user cost" will depend on expectations of future prices and costs of production, as well as the interest rate which mediates the economic tradeoff between the present and the future.

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[1] These ideas can be traced to the early 20th Century, see L.C. Gray, "Rent Under the Assumption of Exhaustibility," Quarterly Journal of Economics, 28 (1914):466-89, and most notably, Harold Hotelling, "The Economics of Exhaustible Resources," Journal of Political Economy 39 (1931):137-75.

But the "user cost" theory is only a part of the framework required to analyze the economics of gas supply. The assets which we can observe and are referred to as "reserves" are only one part of a spectrum of potential gas resources. Gas "reserves" are the end result of an involved and uncertain series of investments. Thus, no theory of gas supply is complete without reference to the determinants of the investment process which (in the vernacular) moves gas "reserves" from possible to plausible to probable to proved and then extracted. The "user cost" theory deals only with the end of this spectrum, the production from known reserves. Some understanding of the determinants of investment in the exploration for and development of new gas reserves is critical to the other end of the gas resource spectrum.

In analyzing the effects of the FERC block billing proposal on future gas supplies, it is thus useful to separate producer supply incentives into two types, which I will refer to as Incentives A and B:

A. Incentives to Explore for and Develop New Reserves

B. Incentives to Produce Efficiently from Known Reserves

Most would agree that from a long term policy perspective, Incentive A is the most important to consider and that the costs associated with A dominate.[2] Reference to a few statistics makes this clear. Table 1 is a reproduction of the latest Department of Energy gas reserves and production data for the period 1963 to 1984. Column one indicates that volume of gas reserves dedicated to interstate pipelines at year end. In 1984 this volume was approximately 90 TCF, and has fallen nearly 10 percent in the last two years. At the same time, the production from these reserves has remained fairly constant, as column 3 shows. Any realistic assumption about production rates from known reserves and future gas demand will lead to the conclusion that after the next five to ten years the majority of gas demand will necessarily be satisfied from reserves which have not yet been proved or discovered, or from imports. The current gas surplus is large (perhaps 3 to 4 TCF), but in the context of the dynamics of the required investments in new reserves, the surplus pales in significance.

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[2] See, for example, the statement of M.A. Adelman and J.C. Houghton, et al., in their comprehensive text Energy Resources in an Uncertain Future: Coal, Gas, Oil, and Uranium Supply Forecasting, Ballinger, Cambridge, MA, 1984, p. 11, "The usual formulation assumes that the only capital in question is the mineral reserve itself and that the only cost is user cost. But user cost is only one particular kind of capital cost. User cost may be and nearly always has been small or imperceptible because of the amount of existing reserves and the flow of increments to reserves over time. Even when nonnegligible, though, user cost may be small relative to the costs of labor and capital needed to find and develop the mineral."

Table G3. Year-end Domestic Reserves, Change in Reserves, and Production Dedicated to Interstate Pipeline Companies, 1963-1984

(Billion Cubic Feet at 14.73 psia and 60 Degrees Fahrenheit)

Year	Dedicated Reserves as of December 31	Net Change in Dedicated Reserves	Production from Dedicated Reserves	Gross Change in Dedicated Reserves[a] [b]	Reserve to Production (R/P) Ratio	Gross Change to Production (GC/P) Ratio
1963	188,540	NA	9,351	NA	20.2	NA
1964	189,165	625	10,015	10,640	18.9	1.06
1965	192,077	2,912	10,371	13,282	18.5	1.28
1966	195,130	3,053	11,137	14,190	17.5	1.27
1967	198,061	2,931	11,820	14,751	16.8	1.25
1968	194,962	-3,099	12,552	9,453	15.5	0.75
1969	187,609	-7,353	13,433	6,081	14.0	0.45
1970	173,556	-14,053	14,092	38	12.3	0.00
1971	161,341	-12,215	14,205	1,991	11.4	0.14
1972	146,906	-14,435	14,207	-229	10.3	-0.02
1973	134,317	-12,589	13,680	1,092	9.8	0.08
1974	120,543	-13,774	12,965	-810	9.3	-0.06
1975	106,816	-13,727	11,992	-1,734	8.9	-0.14
1976	98,282	-8,534	11,389	2,854	8.6	0.25
1977	92,889	-5,393	10,921	5,527	8.5	0.51
1978	93,993	1,104	10,865	11,970	8.7	1.10
1979	97,299	3,306	11,536	14,842	8.4	1.29
1980	97,102	-197	11,604	11,407	8.4	0.98
1981	98,339	1,237	11,959	13,196	8.2	1.10
1982	98,711	371	10,933	11,306	9.0	1.03
1983	94,498	-4,213	9,497	5,284	10.0	0.56
1984	90,216	-4,282	10,344	6,062	8.7	0.59

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[a] Gross change in dedicated reserves represents the net effect of all additions and revisions to the year-end reserve estimates. It is computed from the difference between year-end 1984 and year-end 1983 reserves, plus 1984 production.

[b] Because of rounding, data may not sum to totals.

Source: • 1963-1983: Energy Information Administration Gas Supplies of Interstate Pipeline Companies, 1983, DOE/EIA-0167(83), October 1984, Table 8.
• 1984: Preliminary data compiled from 1984 FERC Form 15 reports.

NA = Not Available

Thus, FERC should be particularly sensitive to the effects of its downstream regulatory policies on not just the gas surplus, but on the investment climate for gas exploration and development as well. The FERC's economic analysis of the block billing proposal not only is not sensitive to these effects, but they are assumed away in the conceptual construction of the FERC economic "model" as articulated in Exhibit S of the rulemaking.

II. The FERC Economic "Model" of the Supply Effects of Block Billing (Exhibit S)

The FERC's conclusions with respect to the supply effects of block billing rely on a conceptual economic model of gas market equilibrium presented in Exhibit S of the rulemaking. It is clear after studying this model that it has received little or no professional review as to its structure or applicability to the questions it claims to answer. The economic importance of the regulatory changes proposed by the FERC, to both gas consumers and gas industry investors, makes it imperative that such a review be provided.

To be useful, an economic model should meet at least two minimal criteria. First, its conceptual structure should capture the important economic determinants of the phenomena being modelled, and second, it should not be so divorced from reality that it is unable to even explain current observed conditions. The FERC model fails on both scores.

A. Conceptual Structure

The FERC model is a static, short-run, partial equilibrium analysis of gas supply and demand. The supply of gas is treated as a flow out of an "inventory" of "storage fields and currently producing fields" (p.S10). The level of these "inventories" can be a matter of public policy, but in any case, the desired inventory level is determined "exogenous to the model" (p. S18). There is no model of the supply of additions to inventories (presumably from new discoveries or non-producing but existing reserves). The model's static equilibrium conditions require that the supply of additions to inventories will always be forthcoming to satisfy the demand for those additions.

Ironically, the author of Exhibit S, in an aside, does admit that "supply enhancing facilities such as Synthetic Natural Gas (SNG) plants will be ignored" by this analysis (P.S10), and asserts that their inclusion would only complicate matters. But just as SNG is ignored, all supplies which result from investment in exploration and development are ignored by this analysis. It is precisely this "complication" which is necessary to even begin a meaningful analysis of the supply effects of block billing.

It should be clear from this brief description of the supply side of the FERC model that it will be incapable of capturing the effects of block billing on Incentive A above, the incentive to explore for and develop new reserves. Since the model only treats the short-run flows out of existing "inventories," it will only be able to consider Incentive B.

But does the model adequately consider Incentive B, the incentive to produce efficiently from existing reserves? Exhibit S claims that the quantity which will be supplied out of "inventories" depends crucially on the "incentive price" (p.S12), which is defined as the ratio of the discounted present value of the producer's fixed contract price with a pipeline divided by the quantity delivered over the life of the contract (pp.S13-14).

Another way of asking whether Incentive B is correctly analyzed by the model is to ask what relationship the FERC "incentive price" bears to the standard concept of "user cost" employed by resource economists, mentioned earlier. FERC's "incentive price" is really the price at time zero of a price trajectory in which there is assumed to be no cost of production and no market or other uncertainty. As such, it is a very limited, special static case of the simplest, standard dynamic resource economic model. This reliance on a static special case is a very serious drawback of the FERC analysis, and limits its application only to reserves which are under contract at price schedules fixed for all time where the marginal cost of production is zero for all time from that reserve. Most resource economists understand that even to model

Incentive B alone, it is necessary to consider all the factors that determine the competitive price trajectory, including costs and price expectations, which even in the most simple case requires a dynamic model.[3]

Thus, Exhibit S fails the first minimal test of an economic model -- it fails to represent the important economic determinants of the behavior being modelled. But does it pass the second test? That is, does it explain current observed conditions in the gas market?

Here, the equilibrium nature of the model divorces it from reality. Now we all would agree that equilibrium models have their place and frequently demonstrate their usefulness, particularly in studying commodity markets. But unfortunately, the gas market is substantially out of equilibrium -- we have a surplus and we have cycled from shortage to surplus over the last decade. It is widely understood that regulation (plus contractual rigidities which have their origin in regulatory policy) is responsible for this disequilibrium condition, and that changes in regulation might rectify this condition (see below). But to assert that block billing plus Order 436 are the policies which will produce equilibrium, based on a model that assumes equilibrium as an initial condition, is to assume away the problem.

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[3] See, for example, Joseph P. Kalt and Anthony L. Otten, "The Theory of Nonrenewable Resource Extraction Under Discontinuous Price Policy," MIT Energy Laboratory Working Paper No. 81-026, Cambridge, MA, May 1981, p. 1. "The nonrenewable nature of some resources...does, however, place an unusually high premium on consideration of dynamic, intertemporal issues; a static analysis cannot be adopted without risking a debilitating loss of realism."

In order to analyze whether block billing will move the gas market toward equilibrium it is necessary to model (or at least understand) the initial disequilibrium conditions in the industry and the costs associated with moving away from that position. The FERC model in Exhibit S would say that a gas surplus could not exist as long as some gas supplies have been decontrolled. This result flies in the face of current observed reality, and thus the FERC model also fails the second minimal test of an economic model.

B. Conclusions Drawn from Exhibit S

Four principal conclusions are drawn by the FERC from their analysis (p. 2). A few brief comments on each of these follows below:

1. Block billing will not create a shortage.

As indicated above, this result is assumed by the FERC analysis and is not derived from it. But a few words about the concept of a gas "shortage" are in order. Technically, a shortage results when there is an excess of demand over the supply available at prevailing prices. Shortages of this type can occur for protracted periods under price controls, for example, or for short periods due to sudden dislocations or demand spikes. Both types of shortages impose costs on individuals and society. But as long as most supplies are not subject to price controls and their prices are allowed to move, protracted shortages will not likely occur. This is independent of whether block billing is or is not implemented.

The question of whether block billing will or will not impose costs through protracted shortages is not the right question to ask. The more general question is whether block billing affects gas supply incentives in a way which imposes costs on individuals and society (just as a true shortage imposes costs). I will argue below that this is the case.

2, 3. Monopoly rents should be distinguished from scarcity rents. Block billing plus Order 436 will eliminate monopoly rents.

The entire discussion of monopoly rents in the context of this problem in Exhibit S is quite puzzling. The author fails to connect the issue of monopoly to any of the structural, cost or regulatory conditions of the gas industry. The argument put forward suggests somehow that gas pipelines possess monopoly power and that somehow producers benefit as a result (pp.S49-51). Under what conditions would a regulated gas pipeline wish to restrict output in order to raise price (as would a textbook monopolist)? The only way that gas pipelines earn "excess" profits is by moving volumes in excess of the test year volumes used to compute their transportation rates.

The incentives exist in the current regulatory system for pipelines to desire lower not higher cost gas moving through their systems, for in this way they move greater volumes of gas. Isolated examples of pipeline monopsony power might be imagined, but not monopoly power under the current regulatory scheme.

This misconception leads one to wonder about the stated benefits of block billing and Order 436 in increasing "the pressure on interstate pipelines to negotiate lower prices with the owners of old gas" (p.S51). Pipelines already have this incentive to minimize purchased gas costs. If this is the purpose of the entire policy change, it is unnecessary.

4. The distribution of scarcity rents depends on retail rate policy.

This conclusion regarding the distribution of economic rents has implications for the efficiency of the block billing policy as well as its equity (rent distribution). As I will argue below, if the distribution of rents through rolled-in pricing induced the inefficiencies that the Commission is seeking to correct, then the transfer of those rents to the retail end of the system through block billing will also induce a set of inefficiencies. What the Commission failed to analyze in Exhibit S (or anywhere else in the rulemaking) is whether the inefficiencies block billing will induce will be greater or less than those induced by the current distribution of rents. Thus, just as rent distribution will depend on retail rate policy, so too will the costs of block billing depend on retail rate policy.

But before discussing these conclusions. let's return to Incentive A.

III. Economic Determinants of Incentive A (Exploration and Development of New Reserves) and the Effects of Block Billing

In the discussion of the FERC economic analysis above it was pointed out that incentives to explore for and develop new gas reserves (Incentive A) was ignored in their model, and that these incentives are a major factor in determining whether adequate future gas supplies will be available at the lowest efficient price.

It was also pointed out that Incentive A can be thought of as an investment problem. How much will producers invest today in finding uncertain supplies which could be produced and sold tomorrow at an uncertain price. Like all investment problems, the economic determinants of this investment incentive hinge on investor expectations of future prices and "market risk," which can be expressed as the variance (or fluctuation) in future prices. (I am not including expectations as to the labor and materials cost of production or variance in these costs under the premise that rational producers will develop and produce from the least costly fields first. Note that block billing, to the extent that it perpetuates price controls on old gas, will continue to cause this inefficiency in gas supplies in the sense that the cheapest sources of supply will not be produced first.)

A. Producers' Expected Trajectory of Future Field Prices

Producers will underinvest in gas exploration and development to the extent that expectations of future field prices are held below those that a competitive gas market would generate. Since field prices are a "netback" price in the sense that the competitive price to the producer will be net of the costs of transmission and distribution, and inefficiencies induced by downstream regulatory policy and pricing will lower the producers' expected path of field prices to the extent that it raises the expected costs of transmission and distribution.

In analyzing the effects of block billing on Incentive A, it is thus important to consider the efficiency of the policy downstream from the producer. For a variety of reasons, block billing can be expected to produce greater downstream costs and thus underinvestment in new gas reserves. Three reasons stand out:

1. LDC Pricing Policy

Block billing is much more than a simple "billing mechanism" in the sense that it grants a property right or an "entitlement" to the rents associated with price controlled old gas directly to local gas distribution companies (LDC's), and other direct customers.[4] To the extent that LDC's attempt to preserve these rents for their relatively inelastic residential customers, then inefficiencies will result in terms of loss or bypass of industrial load. When given the opportunity, many LDC's and their state regulators have and will pursue such a pricing policy.[5]

2. Gas Supply Transaction Costs

The block billing entitlements program will grant LDC's and other direct customers a bidding advantage over the pipelines in the field, just as the NGPA old gas "cushion" granted interstate pipelines a bidding advantage over the intrastate pipelines for new gas supplies early in its implementation. It is not at all clear that the LDC's and end users who will now possess the cushion of old gas will be more efficient than pipelines in terms of the costs of gas supply transactions. If anything, the rise in the number of transactions, by itself, will increase these costs.

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[4] There seems to be some confusion about whether block billing is a "billing mechanism" or an "entitlements program." For the program to have the effect that the FERC claims for it, it has to be an entitlements program. Block billing would thus grant customers the right to take their Block 1 entitlement and cut back on or substitute for Block 2 gas. See statement on p. S32, "(If LDC's were to block bill), it must be expected, therefore, that each customer would decrease the quantity purchased of the high priced gas and, thereby, lower the average price of gas to himself." If pipelines are forced to block bill, this same behavior must be expected of LDC's.

[5] This problem is not lost on the general public, even in the consuming states. See the lead editorial, "Encouraging Competition in Natural-Gas Prices," Minneapolis Star and Tribune, October 14, 1985, p. 14A, "(The block billing rule)...would weaken the market and push gas cost up by twisting prices to the short run advantage of residential users.... Many industries, for example, could quickly switch to lower cost oil from high-priced gas, thus depriving gas producers of funds to develop new gas fields and to invest in technology that increases yields from older fields.... An attempted special favor for one class of consumers would backfire at the expense of all."

3. Damages to Long Run Pipeline Service

Coupled with the unilateral contract demand reduction options of Order 436, block billing will also harm the investment climate surrounding the provision of pipeline services. In a regulated system, financial distress can only increase the cost of providing essential services. Producers can be expected to view these increased costs and diminished service as a depressing influence on expected future field prices.

B. Variance of Future Prices (Market Risk)

Producers will underinvest in gas exploration and development to the extent that the risk underlying these assets (as measured by the variance in future prices) increases, without a corresponding increase in expected future prices to reward them for bearing this risk. This could occur where downstream regulatory policy induces greater fluctuations in the new gas price than would be expected by market forces alone. This would be a consequence of continued regulation of some gas prices which acts to "leverage" the fluctuations in unregulated gas prices.

This effect is alluded to in Exhibit S (p. S47) with regard to SNG projects. FERC's argument there concludes "that a system of pricing and regulation that focuses market pressures on current vintage prices and production and isolates old vintage prices from those pressures serves to increase the risk of SNG projects substantially." In precisely the same way, block billing, by "isolating" regulated old gas prices for gas customers, will increase the risks associated with any new gas investment project, whether it involves exploration and development of new reserves or the construction of SNG facilities (if SNG is in fact the next cheapest source of supply.)

IV. THE FERC's Economic Justification For Block Billing

To this point my comments have primarily considered the negative effects on gas supply of the block billing proposal and the FERC economic defense of this proposal in Exhibit S. Is there a compensating positive economic justification for the block billing proposal which outweighs these supply concerns?

The FERC's justification for the block billing proposal is radical. Their argument is that block billing is necessary because "full rolled-in pricing...is an unjust and unreasonable rate, charge, or practice under Section 5 of the NGA" (p. 16).

Four economic conditions are cited as being required for a just and reasonable rate for natural gas (p. 16-17). To be "just and reasonable" FERC says a rate must:

- Promote efficiency in production and consumption;
- Permit "fair competition;
- Not lead to wasteful depletion of scarce resources;
- Not distort the benefits of access to transportation.

Only the first of these has any unique economic content. The last three conditions are merely partial restatements of the efficiency criterion.

The FERC asserts that "full" rolled-in pricing is inefficient for all four reasons (I will address this below). Even if we were to assume they were right abut this, it is then admitted that block billing does not eliminate rolled-in pricing. Instead "partial" rolled-in pricing is being substituted for "full" rolled-in pricing (pp. 26-27). If "full" rolled-in pricing is unjust and unreasonable under the criteria above, one has to wonder how "partial" rolled-in pricing meets the same criteria. The only conceptual economic distinction between "full" and "partial" rolled-in pricing, as the FERC has defined it, is that "partial" rolled-in pricing helps level the transportation playing field (or so it claimed). But that is only one of the four criteria for "just and reasonable" rates. FERC's entire conceptual economic justification for block billing, as articulated in the Supplemental Notice, is self-contradictory.

A. Is Rolled-in Pricing Inherently "Unjust and Unreasonable?"

Technically, rolled-in pricing is just one form of average-cost pricing. There is nothing inherently inefficient about average cost pricing as long as input prices are free to move. In fact, in cases where a firm's costs fall with expanding output (say, due to economies of scale) it is inefficient not to price on an average cost basis. This is the principle behind pipeline transportation rates, for example, where the various non-gas costs of doing business (labor, materials, etc.) are "rolled-in" to determine average rates. Because of the scale economies in pipeline transportation, marginal costs are less than average costs and competitive marginal cost pricing would put the firm out of business. To continue this analogy, if there were government wage floors on the pipeline's employees which propped up salaries, then these higher wages would be rolled into the pipeline's transportation rates and inefficiencies would result (i.e., the firm would use too little labor relative to capital and the consumer would use too little of the pipeline transportation service). But note that the inefficiency results directly from the wage controls and not from average cost pricing. In exactly the same way, the inefficiency which FERC seeks to eliminate with block billing results directly from the controls on old gas prices and not from the practice of rolled-in pricing.

The Commission goes to great pains to dispute the notion that price controls on old gas and not "rolled-in pricing are the source of the gas market distortions of recent years (pp. 37-39). But the FERC's response (p.38) is circular. Essentially, they argue that without rolled-in pricing, the old-gas cushion would not cause economic distortions, therefore, the source of the problem is rolled-in pricing. Recall my example above, rolled-in pricing is nothing more and nothing less than average-cost pricing, and is not inherently distorting if input prices are free to move.

B. Does Block Billing Level the Playing Field?

One of the key features of block billing from the FERC's point of view is that it prevents pipelines from employing their endowments of old gas to their competitive advantage by selectively moving this gas through their Order 436 transportation programs. But "old" gas is not the only gas which may give a particular pipeline a competitive advantage or disadvantage. That is, unequal endowments of Block 2 gas supplies and contract terms (such as market-outs and take-or-pay exposure) may create pipeline competitive problems.

More significantly, it is widely admitted that all the block billing proposal does is transfer the old gas cushion to the local distribution company level of jurisdiction. Since in the new Rule's environment LDC's will be competing against pipelines in the field for gas supplies, block billing will tilt the playing field in favor of the LDC's in bidding for gas supplies, just as the NGPA gave interstates a bidding advantage over intrastate pipelines in the field during its initial years of implementation. This would lead to all the same inefficiencies of rolled-in pricing in production and consumption that FERC recites in their block billing justification.

FERC does state that for the benefits of block billing to be achieved, state PUC's must mandate block billing at the LDC level (p. 23). But is this sufficient? Suppose that every state did require LDC's to block bill to each of its customers. Suppose an industrial user on an LDC network received block billed gas. What is to prevent the industrial user from taking only its Block one entitlement from the LDC, and then procuring its remaining gas in the field with non-discretionary pipeline transport? In this case the industrial user has the economic advantage over both the LDC and the pipeline in the field market and the playing field is not level. The lesson here is obvious. As long as some gas remains under price controls it is impossible to pass these rents downstream in hopes of eliminating the potential competitive advantages that this gas could represent. Another way of saying this is that it is impossible to eliminate the claimed negative effects of rolled-in pricing as long as some gas remains under price controls. It should be obvious, then, that rolled-in pricing is not the fundamental problem. The problem is continued controls on the pricing of old gas.

On balance, if one reviews the stated economic rationale for the block billing proposal, the FERC definitions of a "just and reasonable" rate policy, and the negative effects of block billing on producer incentives to explore for an develop new gas reserves, it is clear that the only gas regulatory policy change which can be justified and can meet all of these criteria includes as a necessary condition the decontrol of old gas prices. When block billing is considered as a "second-best" substitute for old gas decontrol, it is my view that its costs outweigh any of its claimed benefits.

APPENDIX B

FINANCIAL PERFORMANCE OF
MAJOR U.S. INTERSTATE PIPELINES

Prepared By
FOSTER ASSOCIATES, INC.

For
NATURAL GAS SUPPLY ASSOCIATION
(NGSA)

October 1985

EXECUTIVE SUMMARY

Economic Performance of Major Interstate Pipelines

I. Introduction

In April 1985, the Natural Gas Supply Association (NGSA) contracted Foster Associates, Inc. (FA) to analyze the financial performance of 25 major interstate gas pipelines selected primarily on the basis of their gas purchases from producers.

Financial data for the interstate operations of the major pipelines are unavailable from Annual Reports to Stockholders (or similar public documents) because such reports reflect the totality of the parent companies' diversified operations, not merely their gas transmission activities. The only publicly available financial information on their pipeline operations is information supplied to the Federal Energy Regulatory Commission (FERC) in an annual report referred to as the FERC Form 2. In that report, audited by recognized public accounting firms, the pipelines provide complete financial data on their gas utility operations.

Therefore, FA was requested to compile the FERC Form 2 data in a consistent, technically sound manner to obtain an accurate portrayal of the actual financial performance of twenty-five selected major interstate pipelines over the period 1977-1984.1/ All allocations necessary to reflect the pipeline segment of the business were made by the pipelines in their reports to the FERC.

1/ The FA Report covers the period 1977-1984. Beginning in 1977, the pipeline companies were required to specifically report in the FERC Form 2 the cost rates for short and long term debt and preferred stock associated with their gas pipeline business. These data are unavailable prior to 1977. Therefore, to avoid any arbitrary assumptions regarding the cost rates of senior capital, the FA study covers the period 1977 through 1984.

II. Summary of Results

The following discussion highlights the findings of the four hundred page FA study, focusing only on the aggregate results for the twenty-five pipeline composite group, not on the results for individual pipelines.

A. Pipeline Profitability

As shown by the table below, over the last five years the pipelines have enjoyed unusually high rates of return on total capital and common equity for a regulated utility.

	1980-84 Average Return on Investment	
	Total Capital	Common Equity
Gas Pipelines	13.1%	15.3%
Industrial Companies	12.1%	13.1%

For reference and to provide perspective on the level of the pipelines' earnings, the average returns achieved by industrial companies (an average for 900 large companies compiled by FA from data supplied by Value Line) are also shown. It is the Subcommittee's opinion that the large group of competitive industrial companies are, on average, exposed to higher business risks than are the regulated interstate pipelines, and, therefore, should command a higher return to compensate for the greater risk.[2] However, instead, as shown, the pipelines have achieved significantly higher returns, and the differential appears to have increased in recent years. For example, in 1984 the twenty-five pipelines achieved an average return on common equity of 16.9 percent versus 13.7 for the Value Line 900 industrial group.

The above data reflects the return for the composite pipeline group. Attachment I lists the 25 pipelines included in the study, and the return on average common equity for each company over the period 1977-1984. The bottom portion of the attachment shows the average and median return for the 25 pipelines. Also shown is the median authorized rate of return for the pipeline composite.[3] As shown, the actual return is always higher than the authorized returns, and usually by a substantial amount. Attachment 2 sets forth the pipelines' returns on total capital (rate base). The results are analogous to those on common equity.

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[2] An example of this greater risk is the fact that each year a number of industrial companies fail and go out of business while this would be a rarity in the regulated pipeline business.

[3] Since an authorized return for many of the pipelines is not available for every year, the median is a more meaningful measure of the central tendency.

The actual return on investment developed by FA was generally much higher than the FERC authorized rates of return for most pipelines. FA was asked to reconcile, or otherwise explain this apparent aberration. The Foster supplemental analysis (included as an appendix in the final report) concluded that the report accurately portrayed the actual financial performance of the pipelines, but that the actual rates of returns reported in the study are not directly comparable with the FERC authorized rates of returns because: (1) the FERC Form 2 financial data include the income and investment in nonjurisdictional utility operations; (2) the FERC authorized rate of return is based on a forward-looking test year, not on actual returns (recoveries in later rate cases are forbidden since it would constitute retroactive rate making); and (3) the final rate decision is usually a compromise that winds up focusing on the allowed revenues and tariff levels exclusively, with an authorized rate of return on rate base generally only available implicitly, or if provided, only to rationalize the settlement agreement.

B. Pipeline Margins

The FA report also contains a substantial body of information regarding pipeline margins, i.e., how much they add to the delivered cost of gas. This data was summarized in two forms: one, which develops the margin per unit of gas delivered by the pipeline, and a second, which calculates the margin per unit of gas delivered to end users. The two measures of pipeline margins were developed because pipelines purchase gas from each other as well as from producers. Consequently, there is a pyramiding of transportation costs, i.e., a pipeline's purchased gas cost includes payments to producers, and also payments to other pipelines for gas as well as for transportation. Stated another way, the volume of gas actually delivered to ultimate consumers of gas is far less than the total of the volumes handled by the individual pipelines. Because of this phenomena, the indicated margin per unit of total combined deliveries significantly understates the unit cost that pipelines actually add to delivered costs to the consumer.

The study shows that pipeline earnings are an important factor in the price consumers pay for gas, as can be seen from the data below, using 1984 as an example:

	1984 Earnings Contributions To Consumer Prices, $/MCF Based on:	
	Sales to End Users	Total Deliveries
Net Operating Earnings	.33	.16
Income Taxes	.22	.11
Total	.55	.27

The first column shows that the pipelines' net operating earnings (including the income taxes these earnings generated) added 55¢/MCF to the cost of gas paid by end users. This amounts to 11 percent of the delivered cost of gas to end users.

The second column shows the same data based on total deliveries by the pipelines. As discussed earlier, the much smaller values result from the fact that the denominator used (total deliveries) include the deliveries from one pipeline to another, not just deliveries to end users.

The common misconception that pipeline earnings are not a significant factor in delivered gas costs comes from the fact that from an individual pipeline perspective, the cost per MCF will be on the total delivery basis shown above. Furthermore, the income taxes necessary to generate these earnings are usually not considered. Consequently, an erroneous conclusion is reached that pipeline earnings add only 16 cents per MCF to delivered gas costs or about three percent. The study correctly shows that pipeline earnings, including taxes, actually add 55 cents per MCF (or 11 percent) and are an important component of delivered gas costs.

Another misconception regarding gas costs is that the only source for meaningful relief on consumer prices is at the wellhead, since transmission costs are too small to have a material impact on the end user prices. The study corrects this misconception. For example, in 1984 pipeline costs accounted for $1.64 per MCF, or about one third of the price paid by gas consumers:

	Pipeline Costs $/MCF Based on:	
	Sales to End Users	Total Deliveries
1984	$ 1.64	$ 0.80
1977	0.77	0.43

The costs are much higher when correctly viewed from the gas going to end users, instead of the unit costs that result from dividing by total deliveries, which is the only perspective available from an individual pipeline. As shown, not only are the pipelines' costs very large, but they have grown enormously over the period, more than doubling since 1977; increasing from $0.77 to $1.64 per MCF.

Some erroneously attribute the increase in pipeline margins to rising gas costs, since gas is used for compressor fuel. However, the rise in the cost of compressor fuel does not explain the increase in margins. Compressor fuel represents a relatively small portion of pipeline costs; in 1984, for example, compressor fuel costs accounted for only $0.11 of the $1.64 per MCF pipeline margin. If compressor fuel costs were eliminated from both the 1977 and the 1984 pipeline costs per MCF, the remaining costs still more than doubled, increasing from $0.74 to $1.53 per MCF. In contrast, the inflation over this same period was only 59 percent.

The large increase in pipeline margins confirms what economic theory would predict will happen when one cost component (wellhead gas prices) of a product is held at an artificially low price, several levels from the ultimate consumer. Since end user prices would then not be constrained by competitive market forces, the downstream costs would inflate to fill the cost vacuum created. In theory, the overseeing regulatory agencies should prevent this, but since regulation is cost based, the focus of the companies will be on cost justification, not cost minimization. Unconstrained by competitive market forces, and with the pipelines focusing on cost justification, costs can be expected to rise rapidly, which the study shows indeed did happen.

C. Pipeline Investment

Over the 1977-1984 period, pipeline sales to end users declined by approximately 7 percent. In such a period of declining volume, it would generally be expected that there would be little need for substantial new pipeline investments, absent major shifts in supply sources and/or consuming centers. Due to the increase in accumulated depreciation charges over time, it would be expected that the pipelines net depreciated investment would shrink. However, the resulting decline in the rate base would curtail profits providing a powerful incentive to prevent this decline from occurring.

The FA study shows that the pipelines' net investment did not decline during this period of declining sales but instead expanded substantially. For example, over the 1977-1984 period, the pipelines accumulated depreciation charges were $7.9 billion, which absent new investment, would have greatly reduced the twenty-five pipelines' 1977 net depreciated investment of $11.3 billion. However, because of new investments during the period (approximately $14.3 billion), the pipelines not only offset the entire $7.9 billion of depreciation, but actually increased their net depreciated investment from $11.3 billion in 1977 to $15.6 billion in 1984. This helps to explain how the net operating earnings over the 1977-1984 period could increase by 67% while sales to end users declined by 7%.

D. Foster Associates Study

Attachment 3 provides a tabulation of the key statistics for the twenty-five pipeline composite. The FA study provides detailed information on each of the twenty-five pipelines and for the pipeline group composite; a detailed description of the methodology used in the study including a map which explains how each number in the study was developed; and a convenient summary of the key assumptions.

Attachment I

GAS PIPELINE RETURNS ON AVERAGE COMMON EQUITY

Company Name	1977 (%)	1978 (%)	1979 (%)	1980 (%)	1981 (%)	1982 (%)	1983 (%)	1984 (%)
ANR Pipeline Co.	18.54	19.36	15.66	14.26	13.99	13.83	16.59	21.36
Arkla, Inc.	16.13	21.75	17.00	18.53	19.92	22.40	14.33	21.17
Colorado Interstate	15.26	17.08	14.62	19.06	16.94	20.13	17.00	26.31
Columbia Gas Transmission Co.	10.91	14.92	14.89	12.85	12.31	5.00	16.03	8.62
Columbia Gulf Transmission Co.	13.21	12.94	13.43	12.36	11.75	13.77	18.57	17.57
Consolidated Gas Transmission Co.	10.16	8.97	11.03	9.20	13.79	11.47	22.40	16.85
El Paso Natural Gas Co.	23.39	14.41	17.31	12.66	15.95	10.35	18.86	14.21
Florida Gas Transmission Co.	18.57	22.40	30.67	23.26	38.47	58.79	41.65	60.71
Mississippi River Transmission Corp.	29.50	24.97	30.06	23.07	18.87	16.85	12.28	19.30
Montana-Dakota Utilities Co.	- 4.21	- 0.73	- 1.07	- 3.90	- 6.26	2.33	- 1.02	0.42
Natural Gas Pipeline Co. of America	19.96	12.86	19.26	15.16	14.14	16.29	17.72	16.85
Northern Natural Gas Co.	14.96	16.09	10.18	9.82	10.39	12.75	17.23	18.87
Northwest Central Pipeline Corp.	24.67	25.86	18.26	18.56	15.96	19.16	16.33	22.00
Northwest Pipeline Corp.	17.96	11.36	17.00	16.45	14.08	13.02	12.27	11.77
Panhandle Eastern Pipe Line Co.	10.67	9.57	9.28	2.36	5.30	- 1.57	9.19	11.43
Sea Robin Pipeline Co. 1/	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Southern Natural Gas Co.	24.52	22.59	18.37	19.00	15.66	17.60	18.97	19.92
Tennessee Gas Pipeline Co.	10.43	9.08	8.44	11.61	13.62	15.41	16.31	17.18
Texas Eastern Transmission Corp.	17.38	15.19	13.40	13.40	7.36	11.47	17.79	19.38
Texas Gas Transmission Corp.	15.39	13.28	12.42	13.09	14.57	13.56	16.86	18.37
Transco Gas Supply Co. 2/	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Transcontinental Gas Pipe Line Corp.	23.17	19.86	26.18	31.76	13.55	25.07	21.99	19.79
Transwestern Pipeline Co.	14.59	12.59	21.58	17.37	15.60	13.76	12.40	15.10
Trunkline Gas Co.	28.44	19.70	18.17	13.08	14.16	10.81	9.64	19.57
United Gas Pipe Line	28.83	26.93	33.14	36.66	30.92	25.96	15.14	12.66
ARITHMETIC AVERAGE	17.49	16.13	16.49	15.61	14.83	16.01	16.45	18.66
WEIGHTED AVERAGE	17.33	15.48	15.61	15.16	14.12	14.45	15.63	16.89
MEDIAN	17.38	15.19	17.00	14.26	14.14	13.77	16.59	18.37
FERC AUTHORIZED RETURNS ON COMMON EQUITY, MEDIAN 3/	12.75	12.75	13.00	12.96	13.12	13.88	14.88	15.40

1/ Excluded because the very high rates of return calculated for Sea Robin reflect tax liabilities passed on to the owners: Sonat Inc., and United Energy Resources, Inc.

2/ Excluded because company has practically no investment in utility plant, and therefore indicated rates of return are not meaningful.

3/ THE FERC Authorized return entry represents FERC rates of return specified in rate cases settled during the year listed and does not take into account authorized rates of return specified in earlier years and still in effect during a particular year. As a result, during the 1980's this entry overstates the median authorized rate of return in effect, because the authorized rates of return grew over this period. Thus, the actual returns may have exceeded the authorized rates of returns by more than shown in the table.

Attachment 2

GAS PIPELINE RETURNS ON AVERAGE RATE BASE

Company Name	1977 (%)	1978 (%)	1979 (%)	1980 (%)	1981 (%)	1982 (%)	1983 (%)	1984 (%)
ANR Pipeline Co.	13.91	14.37	12.69	12.12	12.28	12.18	13.96	17.40
Arkla, Inc.	12.72	15.07	12.63	14.06	15.77	16.49	11.64	16.14
Colorado Interstate	10.66	11.56	10.80	13.09	13.03	14.25	13.30	19.18
Columbia Gas Transmission Co.	9.22	11.57	11.32	10.64	10.59	7.68	12.26	8.83
Columbia Gulf Transmission Co.	10.26	10.19	10.47	10.31	10.49	11.66	13.73	13.59
Consolidated Gas Transmission Co.	8.60	8.15	9.30	8.89	11.07	10.56	15.29	13.06
El Paso Natural Gas Co.	13.66	10.38	12.23	10.97	13.26	11.43	14.46	13.34
Florida Gas Transmission Co.	13.53	15.79	13.45	17.64	20.40	29.91	25.36	34.56
Mississippi River Transmission Corp.	20.27	18.77	23.27	19.56	17.25	15.68	12.12	18.02
Montana-Dakota Utilities Co.	3.03	4.40	4.40	3.70	2.87	6.07	4.59	5.42
Natural Gas Pipeline Co. of America	12.90	9.90	13.21	11.47	12.18	12.96	14.12	13.77
Northern Natural Gas Co.	11.52	12.50	9.33	9.1[illegible]	11.10	11.79	14.53	15.84
Northwest Central Pipeline Corp.	20.37	19.93	15.14	15.[illegible]	14.13	16.26	14.65	18.29
Northwest Pipeline Corp.	11.58	9.66	12.77	13.29	12.43	13.38	12.98	12.64
Panhandle Eastern Pipe Line Co.	9.46	8.92	9.13	5.64	7.15	4.64	10.33	11.47
Sea Robin Pipeline Co. 1/	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Southern Natural Gas Co.	16.19	16.11	15.33	16.18	13.39	14.37	16.07	16.71
Tennessee Gas Pipeline Co.	9.49	8.71	8.58	10.56	12.23	13.71	14.06	14.77
Texas Eastern Transmission Corp.	12.03	11.51	10.74	11.60	9.06	11.58	14.80	15.87
Texas Gas Transmission Corp.	12.62	11.56	11.16	11.56	12.08	12.90	15.16	16.17
Transco Gas Supply Co. 2/	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Transcontinental Gas Pipe Line Corp.	11.10	10.46	12.12	14.39	9.64	13.66	14.55	14.05
Transwestern Pipeline Co.	11.46	10.52	17.08	14.76	14.07	12.98	11.43	13.85
Trunkline Gas Co.	17.07	13.81	13.35	12.04	13.32	11.23	10.74	14.02
United Gas Pipe Line	20.13	19.98	23.11	26.73	22.63	20.01	13.90	13.20
ARITHMETIC AVERAGE	12.69	12.36	12.77	12.78	12.63	13.28	13.65	15.23
WEIGHTED AVERAGE	12.42	11.83	12.06	12.18	12.22	12.56	13.83	14.62
MEDIAN	12.03	11.56	12.23	12.06	12.28	12.96	13.94	14.05
FERC AUTHORIZED RATE OF RETURN MEDIAN 3/	9.66	10.12	10.08	10.75	11.16	11.36	12.86	13.36

1/ Excluded because Company reports no income tax liability, and therefore rates of return are non-comparable; income tax liability is passed on to parents; Sonat, Inc. and United Energy Resources, Inc.

2/ Excluded because company has practically no investment in utility plant, and therefore indicated rates of return are not meaningful.

3/ THE FERC Authorized return entry represents FERC rates of return specified in rate cases settled during the year listed and does not take into account authorized rates of return specified in earlier years and still in effect during a particular year. As a result, during the 1980's this entry overstates the median authorized rate of return in effect, because the authorized rates of return grew over this period. Thus, the actual returns may have exceeded the authorized rates of returns by more than shown in the table.

Attachment 3

Summary of Key Statistics on 25 Pipeline Companies From Foster Associates Study on the Financial Performance of Major U.S. Interstate Pipelines

	1977	1978	1979	1980	1981	1982	1983	1984
Return on Total Capital (Rate Base) (%)								
Gas Pipelines (Weighted Average)	12.4	11.8	12.1	12.2	12.2	12.6	13.8	14.6
Value Line 900 Industrials	12.3	12.9	14.8	13.7	12.9	10.3	11.2	12.7
Authorized Rate (Median)	9.7	10.1	10.2	10.8	11.2	11.4	12.9	13.4
Return on Common Equity								
Gas Pipelines (Weighted Average)	17.3	15.5	15.6	15.2	14.1	14.5	15.6	16.9
Value Line 900 Industrials	14.6	15.2	17.9	15.8	14.3	10.5	11.5	13.7
Authorized Rate (Median)	12.8	12.8	13.0	12.9	13.1	13.9	14.9	15.4
Authorized Rate (Weighted Average)	13.4	12.1	13.0	13.3	13.5	13.8	14.1	14.1
Gas Volumes (TCF)								
System Sales	12.8	13.2	14.1	14.1	14.3	13.0	11.2	11.2
Transport for Others	2.6	3.0	3.4	3.6	4.4	4.1	4.0	5.2
Total Deliveries[2]	15.3	16.1	17.5	17.8	18.7	17.1	15.3	16.4
MEMO: Gas Sales to End Users	8.5	8.8	9.6	9.5	9.5	8.6	7.8	7.9[1]
Net Operating Income								
Total (Billion $)	1.57	1.61	1.73	1.86	2.03	2.31	2.60	2.63
Per MCF of Total Deliveries ($/MCF)	.10	.10	.10	.11	.11	.14	.17	.16
Per MCF of Gas to End Users ($/MCF)	.18	.18	.18	.20	.21	.27	.34	.33[1]
Pipeline Markup Per MCF to End Users ($/MCF)[1]								
Operating and Maintenance Expense	.30	.35	.42	.51	.62	.77	.85	.86
Depreciation	.12	.13	.13	.14	.16	.17	.17	.17
Taxes Other Than Income	.03	.04	.06	.07	.05	.06	.06	.06
Income Taxes	.13	.13	.12	.12	.14	.16	.21	.22
Net Operating Income After Tax	.18	.18	.18	.20	.21	.27	.34	.33
Total[2]	.77	.83	.91	1.04	1.17	1.42	1.62	1.64
Cash Flow Analysis (Billion $)								
Total Cash Flow	2.72	2.74	3.43	3.38	3.97	4.42	4.33	4.64
Additions to Gas Plant	1.09	1.54	1.60	1.99	2.71	2.73	1.35	1.32
Surplus to Gas Plant	1.63	1.20	1.83	1.39	1.26	1.69	2.98	3.32
Cash Flow per MCF to End Users ($/MCF)	.32	.31	.36	.35	.42	.51	.56	.59
Gas Plant Investment (Billion $ at End of Year)								
Gross Investment	22.38	23.85	25.44	27.37	29.80	32.24	33.47	34.58
Accumulated Depreciation	(11.04)	(11.99)	(12.97)	(14.08)	(15.18)	(16.43)	(17.73)	(18.97)
Net Depreciated Investment[3]	11.33	11.86	12.46	13.29	14.61	15.81	15.74	15.61

[1] Arkla, Inc. did not report gas sales to end users in 1984 Form 2 so their 1983 figure was used in 1984 composite data to have a consistent data series for 25 pipelines.

[2] Totals might not equal the sum of the columns due to arithmetic rounding.

[3] Net depreciation might not equal the gross investment minus the accumulated depreciation due to arithmetic rounding.

Senator **Nickles**. Thank you very much, Mr. Hentschel. We appreciate your comments.

Senator Bradley, we're pleased that you have joined us. Did you have any opening remarks?

STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator **Bradley**. Mr. Chairman, I won't make any lengthy opening remarks. I'll simply say I'm looking forward to hearing from the witnesses today, and particularly I am interested in hearing how this voluntary contract carriage is working because, you know, lurking in the background is, of course, mandatory contract carriage.

I think that we'd prefer to see things work on a voluntary basis, but clearly it's my intention that if voluntary rules don't produce more gas flowing through the pipelines at reasonable prices for consumers and moving gas that producers have, that lurking in the background will be some effort on the mandatory side.

Beyond that, I have not much else to say. I'm listening anxiously to hear how many people think the present rule is working well, and any suggestions that might be offered to improve it.

Senator **Nickles**. Thank you very much, Senator Bradley. You've always had an interest in contract carriage, and I appreciate that, and I'll look forward to working with you on it.

We also have our next panelist, Mr. C.M. Harrison, who is a senior vice president of Exxon Co. from Houston, TX.

STATEMENT OF C.M. HARRISON, SENIOR VICE PRESIDENT, EXXON CO. U.S.A., HOUSTON, TX

Mr. **Harrison**. Good morning, Mr. Chairman, and members of the subcommittee.

I am C.M. Harrison, senior vice president of Exxon Co. U.S.A. Part of my responsibilities include management of Exxon's domestic natural gas business.

I appreciate the opportunity this morning to testify on Order 436 and the notice concerning block billing issued in October by the Federal Energy Regulatory Commission.

Senator Nickles, we appreciate your interest on these issues which are very important to the well-being of the natural gas industry. We commend you for the strong leadership role you have assumed in natural gas both in the legislative arena, and more recently in the FERC's rulemaking proceedings. Like you, we are convinced that the interests of producers and consumers would be best served by the decontrol of all gas at the wellhead.

Exxon strongly opposes the FERC's block billing proposal, but we support most aspects of FERC's Order No. 436. By providing for open and nondiscriminatory transportation, Order 436 can improve access to alternate markets by producers, local distributors, and end users. However, there is a condition in that order that we do oppose—that condition in the order which requires pipeline companies to allow customers to reduce their firm service demand we believe is unnecessary, is contributing to the pipeline companies 'reluctance to become transporters, is poor policy; it may be unlawful, and it should be eliminated on rehearing.

We believe the provision is unnecessary to the workings of Order 436, because pipeline customers can gain access to transportation and the market through the use of existing contract flexibility and in most cases improved negotiations where needed.

We also support FERC's decisions concerning the settlement of take-or-pay obligations and announcing a new policy for expeditious considerations of applications for abandonment in certain situations. Take or pay is a problem which is being resolved through negotiations. No additional regulations are needed.

Exxon has settled take-or-pay obligations totaling $700 million. We do have a remaining $600 million in take-or-pay which we are actively working on. A large part of this remaining amount is of recent vintage.

Let me now turn to block billing. As mentioned, we are opposed to block billing. The United States is now operating with only 9 years' supply of gas reserves in the lower 48. We must be mindful that the surplus capacity which we have today can rapidly disappear. We all remember the gas shortages the Nation faced in the 1970's, and our supplies are not that long; we should not grow complacent.

If block billing were implemented, block 2 prices would be depressed, leading to a loss of supplies which we estimate would total 1 to 2 trillion cubic feet per year. Block prices would also be more firmly locked in place, well below the market, resulting in an additional loss which has been estimated to be in the 27 to 48 trillion cubic feet of reserves. In total, these are very large reserve losses which this Nation badly needs.

In addition to the supply effects, block billing will add new distortions and inequities in the market. Regional disparities will be magnified. Some industrial concerns fortunate enough to be allowed some block 1 low-cost gas would be given an unfair competitive edge. New businesses would not be allowed to compete on an equal footing. These inequities and distortions will inevitably lead to more and more and more regulations. The setting up of an old gas entitlement system through block billing reminds us of the disastrous oil entitlements program of the 1970's and 1980's.

In short, we believe that block billing will not accomplish any positive goals, and it should be discarded. The best long-lasting solution is total wellhead decontrol of all gas. Such would result in a market-responsive industry more able to meet the Nation's future natural gas requirements. Decontrol would benefit all consumers by assuring a more efficient operation of the market.

Absent decontrol legislation, we believe the FERC should exercise its authority by acting to establish just and reasonable prices for old gas which would undoubtedly bring them more in line with the market.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Harrison follows:]

SUMMARY STATEMENT OF C. M. HARRISON
SENIOR VICE PRESIDENT, EXXON COMPANY, U.S.A.
BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
November 21, 1985

Exxon Company, U.S.A. supports most aspects of the Federal Energy Regulatory Commissions' (FERC) Order Number 436, but does recommend that one condition imposed on transporters of natural gas be eliminated. Exxon strongly opposes the Block Billing mechanism under study by FERC.

The major benefit of Order 436 will be increased access to transportation on the part of consumers and producers alike. This will improve the efficiency of the natural gas market by allowing competition and market forces to operate more freely. However, the 25 percent reduction in service provisions should be eliminated. Making this a condition of pipeline transport is unnecessary, results in contract abrogation, and is contributing to the delay in pipeline companies becoming transporters.

Although take or pay obligations continue to be a concern to some in the industry, the public record demonstrates that contract issues are being resolved by producers and pipelines through negotiations and no additional regulation is needed. Exxon and its pipeline purchasers have reached settlements discharging obligations totaling $700 million and continue to work toward a satisfactory resolution of the remaining balance, much of which is of recent vintage.

In addition to other adverse effects, Block Billing would significantly reduce gas reserves which are badly needed. The nation is currently operating with only 9 years of gas reserves at present consumption rates, production is not being replaced by new discoveries, and the existing spare capacity can rapidly disappear. Block Billing would lead to reduced gas exploration and drilling activity with consequent reduction in gas supplies estimated at 1 to 2 Tcf per year lower reserve additions. In addition, it would tend to lock in-place old gas prices below the market thereby preventing the recovery of an additional 27 Tcf to 48 Tcf of gas from proven gas fields.

Block Billing would also create additional distortions, inequities, and uncertainties. It would give false market signals by making gas available at below-market prices. It would set in place an inefficient "old gas" entitlements program which would lead to more and more regulations which attempt to cope with the distortions and inequities created. In this regard, we are reminded of the disastrous oil entitlements program of the recent past.

In short Block Billing will not accomplish any positive goals and should be discarded.

The best way to remove distortions, inequities, and to allow the market to balance supply and demand is to decontrol the wellhead price of gas. Such action on the part of Congress in conjunction with non-discriminatory transportation under Order 436 would result in a market responsive industry more able to meet the nations future natural gas requirements at reasonable prices to the consumer. Absent decontrol legislation, the FERC should exercise its authority by acting to establish a market defined just and reasonable price for "old gas".

STATEMENT OF C. M. HARRISON
SENIOR VICE PRESIDENT, EXXON COMPANY, U.S.A.
BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION,
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

November 21, 1985

I am C. M. Harrison, Senior Vice President of Exxon Company, U.S.A. Part of my responsibilities include management of Exxon's domestic natural gas business. I appreciate this opportunity to testify on Order Number 436 and the notice concerning Block Billing issued in October by the Federal Energy Regulatory Commission ("FERC"). As a major producer of natural gas in the United States, Exxon is vitally concerned with the FERC's Order 436 and proposed Block Billing rule.

INTRODUCTION

Exxon supports most aspects of FERC's Order Number 436; however, we strongly object to the Block Billing proposal. If adopted, Exxon believes Block Billing will decrease gas supplies, create additional distortions, inequities, and uncertainties, give false market signals by making gas available at below market prices, and set in place an inefficient "old gas" entitlements program which will lead to more and more regulations to cope with the distortions created.

The natural gas industry is in the midst of a difficult transition from a supply-short, regulated industry to a market-oriented industry. Block Billing will aggravate this transition and increase the likelihood that a significant part of the nation's natural gas production will be forever regulated. The only long-lasting solution to distortions in the natural gas industry is the total decontrol of all natural gas wellhead prices. Such action, which should be taken by the Congress, would benefit all consumers by allowing market forces to work to most efficiently balance supply and demand.

While only the Congress has the authority to decontrol natural gas prices, there are steps the FERC can take to provide the framework for a more efficient market. In that regard, my comments today will focus on the new transportation regulations covered by the FERC's Order 436 and its Block Billing proposal.

TRANSPORTATION

In Order Number 436, the FERC issued regulations which can greatly facilitate the transportation of natural gas for producers, distribution companies, and end-users. As industry has moved from a supply-short, heavily regulated environment of the 1970s to the more competitive, supply-long buyer's market of the mid-1980s, interest in access to transportation has increased. The FERC 's Special Market and Blanket Transportation certificate programs of the last three years, have demonstrated that widespread access to transportation can increase competition and efficiency in natural gas markets. If the interstate pipelines voluntarily participate in the transportation programs as authorized in Order Number 436, market efficiency will further increase. Natural gas consumers will be able to shop the market for the best source of supply, distribution companies will have additional flexibility for maintaining the system supply needed to meet the requirements of their customers, and producers will have additional outlets for their product, which will be a positive stimulus for new development of needed natural gas supplies. We support FERC's efforts to establish open transportation in interstate pipelines.

However, most interstate pipelines have not yet elected to use the new transportation programs. According to reports in the press, pipelines frequently cite the FERC condition that allows firm service sales customers of pipeline companies who choose to become transporters to reduce or convert contract demand up to 25% per year. This amounts to a regulatory abrogation of purchase contracts with pipelines. There is, of course, a serious legal question whether the FERC has authority to allow such contract abrogation as a condition of transporting natural gas in interstate commerce. In any event, it is not good policy.

Furthermore, this condition is unnecessary to achieve the objectives of the new transportation program. Many customers have sufficient flexibility under their existing contracts to purchase supplies from others. Where needed, negotiations can, and we believe would, eliminate contract restrictions so that buyers could have effective access to alternate sources of gas and transportation. The FERC can facilitate the negotiation process by expediting approval of amended contracts.

Elimination of the 25% per year reduction in service provision from Order 436, which we recommend, would remove one of the principal objections that pipelines have to the rule and combined with approval of a satisfactory rate structure would facilitate their election to become transporters.

In addition to supporting FERC's efforts to establish more open transportation in interstate commerce, we support FERC's decision to reaffirm its April 1985 Policy Statement concerning the settlement of take-or-pay obligations and its establishment of a new policy for the expeditious consideration of applications by producers for abandonment of jurisdictional gas sales in certain situations. As the FERC has noted, interstate gas pipelines and gas producers have been successfully negotiating settlements of large amounts of liability arising under take-or-pay provisions of gas sales contracts.

Although take-or-pay obligations continue to be a concern in the industry and are also quoted as a reason pipelines have not yet agreed to be transporters, the public record demonstrates that no additional regulation is needed beyond that which the FERC has announced in its policy statements. Gas producers and the interstate gas pipelines can effectively resolve remaining contract issues if the FERC continues its policy of encouraging and facilitating settlements.

In Exxon's case, we have made progress in our take-or-pay negotiations with interstate pipelines. Out of a total of $1.3 billion take-or-pay obligations our pipeline purchasers incurred with us since 1981, we have negotiated settlements discharging obligations totaling about $700 million, and continue to work toward a satisfactory resolution of the balance, much of which is of recent vintage.

Exxon and, we believe, many others, stand ready to accept the challenge of the more competitive market that is evolving from more open transportation access to the markets. Exxon has shut-in gas to sell. We have recently reorganized our Natural Gas Department to enable us to be a more effective competitor and broaden our market participation--to sell more of Exxon's gas directly to local distribution companies and end-users who are electing to buy gas from non-traditional suppliers.

BLOCK BILLING

Exxon is strongly opposed to Block Billing. We are convinced Block Billing will be detrimental to the nation's long term natural gas supply, will add to the regulatory morass, and will add new distortions and inequities to the marketplace.

Provisions Of Block Billing

Before discussing each of these points, it will be helpful to review Block Billing. Block Billing would divide gas into two blocks for pipeline billing purposes. Block 1 would consist primarily of old gas with regulated price ceilings well below the market. This gas would be arbitrarily allocated to pipeline customers based on their purchases during a six year period ending in 1984, thus providing these customers a windfall and an advantage over others without Block 1 gas.

Block 2 would consist of all remaining supplies, including some regulated higher priced gas and deregulated gas. The average price of gas in Block 2 is now above the market level, and is marketable today only because it is rolled-in with below market, Block 1 gas. By eliminating the roll-in, Block 2 prices would be forced down toward market levels. With no change in Block 1 prices, and lower Block 2 prices, substantial revenues would be lost to the gas producing sector.

Supply Effects

Studies already in the record show producers revenues would be reduced by $3-6 billion per year as a result of Block Billing. Our own analysis supports an estimate in that range. A $3-6 billion reduction in revenues is equivalent to 30-60% of total gas drilling expenditures in 1984. This loss of revenue will cause producers to cut back exploration and development activity beyond even current depressed levels. Furthermore, legal challenges to FERC's authority to issue a Block Billing rule can be expected. These challenges, combined with the increased uncertainty created by continuing changes in the regulatory environment, will further retard drilling activities.

We estimate 1 to 2 Tcf fewer reserves will be found during the first year following Block Billing if it were placed in effect as proposed. Although we have not sought to estimate the impact beyond one year, the cumulative longer term impact would likely be large.

Block Billing will also tend to lock in-place old gas at prices below the market and below the cost to develop new supplies. DOE and others have published estimates that between 27 and 48 Tcf in additional reserves would become economic to develop if market prices were allowed for old gas reserves. Thus, the combined supply penalty of Block Billing and failure to deal with the level of old gas prices would be some 1 to 2 Tcf/year in Block 2 reserve additions for some time and a loss of 27 to 48 Tcf in Block 1 reserves. When considering these losses to reserves, it should be recalled that U.S. Lower-48 gas reserves have fallen from 291 Tcf at year-end 1970 to 163 Tcf at year-end 1984, and that it was only a short time ago that the natural gas industry was faced with a substantial shortage of gas. Current proven reserves in the Lower-48 represent only nine years supply at today's production rates. We are now operating with a much smaller reserves base than in the past, and shortages in the supply of this vital energy resource could again develop very rapidly.

Gas prices have already fallen sharply in response to market pressures in the face of the current surplus deliverability. Competition among producers for incremental sales is intense. A spot market has developed and prices are falling rapidly. Since the first of the year, market prices for gas are off some 30%, from about $3.00/MBtu to about $2.00/MBtu. Prices today are well below the level needed to replace current production with new reserves, and further sharp drops in exploration and development drilling can be expected.

Gas well completions in 1984 were some 16,700, as compared to nearly 20,000 in 1981, and are already running 5% below 1984 levels for the first half of 1985 and trending downward.

Exploratory drilling, which are the wells that ultimately generate new reserves, has been especially hard hit. Only about 1500 exploratory gas wells were completed in 1984, down from over 2500 in 1981. The total in 1985 will be even lower.

Exxon, like the rest of the industry, is responding to the lower price outlook and increased uncertainty. We have reduced our gas development drilling planned for 1986 by 20%. We are also reducing our natural gas exploration efforts.

There will no doubt be even greater adjustments over the next few months as lower prices take their toll on the industry.

With the current surplus in deliverability, some reduction in drilling activity is to be expected as market forces work to bring supply and demand into balance. However, we see a grave danger for the nation in being complacent about the temporary gas bubble, and we do not believe the FERC should take steps to artificially reduce supplies below the level dictated by the market. We are particularly concerned with the introduction of Block Billing into this environment where the market has already over-reacted and prices have dropped below levels needed to support exploration and development of reserves necessary to replace production. Besides the obvious effect on supply development, a reduction in producer revenues in the $3-6 billion per year range will have serious repercussions for many who do business with the energy industry, including well service companies, drilling contractors, and financial institutions with energy loans. Royalty income to producing states, the Federal Government, and thousands of individual royalty owners would also be reduced under Block Billing.

In addition, the lower domestic supplies would also lead to increased imports, thereby aggravating the U.S. balance of payments deficit.

Distortions

Contrary to the FERC's assertion, Block Billing will add to, not eliminate, market distortions. Block Billing moves the market distortions downstream to distributors and end-users creating a "cushion" at the distributor level. This below-market price gas cushion would be available for distributors to outbid pipelines for gas when supplies tighten in the future, leading to the volatile price behavior FERC alleges it intends to eliminate with Block Billing.

Block billing will not "level the playing field" for pipelines. Gas cost differentials across interstate pipelines will not be eliminated. The variation in Block 2 gas costs across these pipelines is about the same as the variation in their current weighted average costs of gas. In addition, access to low-cost gas will still vary widely across pipelines. Those pipelines having greater access, largely due to historical circumstances rather than to superior economic efficiencies, will have a higher base through put than their less fortunate competitors with less access to old gas.

Adoption of FERC's Block Billing proposal will create new inequities among consumers. Allocation of "old gas," with regulated prices below market levels to distributors and industrial and other end-users based on historical consumption patterns, will result in varying natural gas costs among competitors within the same area and/or in gas cost differentials across different regions. Moreover, new users of gas could be put at a competitive disadvantage since they are not, under FERC's proposal, entitled to an allocation of old, low-priced gas. This creates a distortion in the new user market and erects a barrier to entry for new firms or plants in such markets. These inequities create tremendous distortions in the market.

In the long term, suppressed prices create shortages which eventually cause higher prices. DOE also predicted in its January 1985 report, Increasing Competition in the Natural Gas Market, that allowing market prices for old gas would substantially decrease overall gas prices because of increased supplies and additional downward pressure on high-priced gas.

Regulatory Morass

Block billing will lead to more and more regulations which attempt to cope with the distortions and inequities created. In that regard, we are reminded of the disastrous "entitlements" program for oil in the 1970s and early 1980s. All entitlements programs require complex rules for allocating supplies. Because state rules need not and will not be consistent across the country, regional disparities, inequities and inefficiencies will impact the competitive position of industrial gas consumers. Administrative hearings, appeals and litigation are sure to accompany such a program as gas users and even states attempt to "explore" for additional "old" gas allocations through legal channels. Additional regulations will doubtless be promulgated to deal with the distortions caused by Block Billing, thus compounding the regulatory morass even further.

SOLUTION

The preferable and only true solution is for Congress to decontrol old gas prices, once and for all removing regulatory uncertainty with regard to gas pricing. If Congress completed deregulation, begun under the Natural Gas Policy Act of 1978, the market would work more efficiently to the mutual benefit of both producers and consumers. Now is a good time for Congress to take such action. There are surplus supplies available, and prices are abnormally low and falling. With deregulation, industry will be able to respond as the surplus is used up and additional supplies are required.

In the absence of legislative decontrol, the FERC has the authority to raise old gas prices to just and reasonable levels represented by the market. It is clear that current old gas prices violate FERC's own definition of just and reasonable prices. Old gas prices are not just and reasonable because (1) they do not "bring about efficiency in both production and consumption of natural gas"; (2) they do not "permit 'fair' competition"; (3) they do "lead to the wasteful depletion of scarce, non-renewable resources" and (4) they are "not appropriate to changing conditions in the natural gas industry."

SUMMARY

In summary, Exxon believes that FERC's Order Number 436 has the potential to facilitate the transition of the natural gas industry to a market-driven industry to the benefit of all concerned. Open access to transportation will improve the efficiency with which the market operates. We also believe the condition imposed on participating pipelines that allows customers to reduce demand by 25% per year is currently inhibiting pipeline company use of these rules, is unnecessary, and is bad policy. We believe this provision should be eliminated.

Finally, Exxon strongly opposes Block Billing. It threatens the availability of long-term, stable supplies at reasonable prices. It will disrupt the transition to a more competitive market already underway in the industry. It shifts distortions downstream, creates new inequities, and will lead to increasingly complex regulations.

Block Billing ignores a major cause of distortions in the natural gas industry--the artificially low, regulated prices on a significant portion of gas in the market. The FERC should exercise its authority and move promptly to reduce these distortions by acting to raise low-regulated prices to just and reasonable prices as defined by the market.

Only Congress can effect the best and lasting solution, decontrol of all natural gas at the wellhead. Now is also a good time for Congress to take that action.

Senator NICKLES. Mr. Harrison, thank you very much for your comments.

Mr. Holland, vice president, Production, of Mobil Oil Corp.

STATEMENT OF HENRY K. HOLLAND, JR., VICE PRESIDENT, PRODUCTION, MOBIL OIL CORP., WASHINGTON, DC

Mr. HOLLAND. Thank you, Mr. Chairman.

Mobil appreciates the opportunity to present its views to the Subcommittee on Energy Regulation and Conservation, and thanks the subcommittee for its willingness to take the time to hear the concerns of producers together with pipelines, distributors, and consumers on this critical issue.

The Federal Energy Regulatory Commission has correctly identified the need for greater freedom of competition in the natural gas market. Certain actions taken by FERC in Order No. 436 such as nondiscriminatory transportation and expedited certification should help to foster competition, but unfortunately those actions are coupled with other features which we consider to be bad policy.

Those features are, one, the right of pipeline customers to back out of their gas purchase contracts with pipelines under certain circumstances; and two, block billing.

We consider these items to be bad policy because they will create significant negative economic consequences, will contribute to gas shortages in the future, and are administratively burdensome.

These policies will continue the market distortions caused by having such a broad range of FERC regulated and nonregulated prices in the domestic natural gas market.

Mobil supports the Commission's effort to increase the accessibility and flexibility of natural gas transportation options. This will improve the ability of sellers to be responsive to the changing needs of buyers, and to compete with alternate fuels.

Mobil is opposed, however, to that portion of Order No. 436 giving buyers a unilateral right to reduce contract purchase obligations by 25 percent per year. We believe this provision could be successfully challenged on legal grounds, and is unnecessary for the achievement of the Commission's goals. Providing one party with the legal right to abrogate its contract is contrary to the foundation of the American business system.

The Commission is attempting to eliminate distortions in the natural gas market in this country, and to permit fast and accurate flow of market signals from the burner tips back to the wellhead. The proposed block billing mechanism will not accomplish that objective. It will lock in old low-price gas supplies for an arbitrarily determined class of customers who will be permitted to purchase that gas at less than market price.

This will perpetuate regional market distortion and will discriminate against new customers who lack access to old gas. The block billing proposal discriminates in particular against smokestack industries, particularly those which have been badly hurt by imports, because the base period is one in which two recessions occurred and in which the U.S. trade balance dropped by nearly $150 billion.

Block billing discriminates against different regions of the United States by perpetuating the historical anomalies created by 31 years of price controls, rather than allowing the market to allocate supplies most efficiently. A combination of continued controls, unrealistically low price ceilings on old gas, and the downward pressure on the price of all other gas supply will inevitably lead to a shortage and higher prices in the future.

Without the necessary cash flow, there will be no incentive to rework old wells, extend existing fields, and recover the additional 27 to 48 trillion cubic feet of old gas supplies estimated by the Department of Energy to be available from realistic pricing. Without the necessary cash flow, it will be impossible to maintain the exploration program required to discover new supplies in the increasingly deeper formations and more hostile environments where future reserves will be found.

The departure from rolled-in pricing and the clear discrimination against new gas consumers poses serious legal issues. Block billing is not consistent with the intent of Congress expressed in the Natural Gas Policy Act of 1978 to move toward a free and national market for natural gas. The substantial legal issues raised by the departure from congressional intent and the anticompetitive effect of the proposal will lead to serious court challenges and industry-wide uncertainties for years to come.

The proposal stands in stark contrast to the Federal Government's policy of reducing overall regulatory burden. Market distortions will continue until there has been total decontrol of domestic natural gas prices. Until that objective is obtained, however, there are certain interim steps which could be taken by the Federal Energy Regulatory Commission.

The Commission should revise Order No. 436 to eliminate unilateral contract abrogation, and should decide to cancel the rulemaking on block billing. In addition, the Commission should use its legal authority under the Natural Gas Policy Act to raise old gas prices to currently existing price levels. Those actions would substantially reduce existing market distortions, eliminate regional inequities, and assure adequate supplies to the consumers at the lowest reasonable price.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Holland follows:]

TESTIMONY OF MOBIL OIL CORPORATION

I am Henry K. Holland, Vice President-Production for Mobil Oil Corporation. Mobil appreciates the opportunity to present its views to the Subcommittee on Energy Regulation and Conservation and thanks the Subcommittee for its willingness to take the time to hear the concerns of producers together with pipelines, distributors, and consumers on this critical issue.

The Federal Energy Regulatory Commission has correctly identified the need for greater freedom of competition in natural gas markets. Certain actions taken by FERC in Order No. 436 such as, nondiscriminatory transportation and expedited certification should help to foster competition, but unfortunately, those actions are coupled with other features which we consider to be bad policy. Those features are (1) the right of pipeline customers to back out of their gas purchase contracts with pipelines under certain circumstances, and (2) block billing. We consider these items to be bad policy because they will create significant negative economic consequences, will contribute to gas shortages in the future, and are administratively burdensome. These policies will continue the market distortions caused by having such a broad range of FERC regulated and nonregulated prices in the domestic natural gas market.

Mobil supports the Commission's efforts to increase the accessibility and flexibility of natural gas transportation options. This will improve the ability of Sellers to be responsive to the changing needs of Buyers and to compete with alternate fuels. Mobil is opposed, however, to that portion of

Order No. 436 giving Buyers a unilateral right to reduce contract purchase obligations by 25 percent per year. We believe this provision could be successfully challenged on legal grounds and is unnecessary for the achievement of the Commission's goals. Providing one party with the legal right to abrogate its contracts is contrary to the foundation of the American business system.

The Commission is attempting to eliminate distortions in the domestic natural gas market and to permit fast and accurate flow of market signals from the burner tip back to the wellhead. The proposed block billing mechanism will not accomplish that objective. It will lock in old low-priced gas supplies for an arbitrarily determined class of customer who will be permitted to purchase that gas at less than market price. This will perpetuate regional market distortions and will discriminate against new customers who lack access to old gas. The block billing proposal discriminates, in particular, against smokestack industries (particularly those which have been badly hurt by imports) because the base period is one in which two recessions occurred and in which the U.S. trade balance dropped by nearly $150 billion. Block billing discriminates between different regions of the U.S. by perpetuating the historical anomalies created by 31 years of price controls rather than allowing the market to allocate supplies most efficiently.

The combination of continued controls, unrealistically low-priced ceilings on old gas, and the downward pressure on the price of all other gas supply will inevitably lead to a shortage and higher prices in the future. Without the necessary cash flow, there will be no incentive to rework old wells, extend existing fields, and recover the additional 27-48 trillion cubic feet of old gas supplies estimated by the Department of Energy to be available under realistic pricing. Without the necessary cash flow, it will be impossible to maintain the exploration program required to discover new supplies in the increasingly deeper formations and more hostile environments where future reserves will be found.

The departure from rolled-in pricing and the clear discrimination against new gas consumers poses serious legal issues. Block billing is not consistent with the intent of Congress expressed in the Natural Gas Policy Act of 1978 to move toward a free and national market for natural gas. The substantial legal issues raised by the departure from Congressional intent and the anticompetitive effect of the proposal will lead to serious court challenges and industry-wide uncertainties for years to come. The proposal stands in stark contrast to the Federal Government's policy of reducing overall regulatory burdens.

Market distortions will continue until there has been total decontrol of domestic natural gas prices. Until that objective is attained, however, there are certain interim steps which should be taken by the Federal Energy Regulatory Commission. The Commission should revise Order No. 436 to eliminate unilateral contract abrogation and should decide to cancel the rulemaking on block billing. In addition, the Commission should use its legal authority under the Natural Gas Policy Act to raise old gas prices to current market price levels. Those actions would substantially reduce existing market distortions, eliminate regional inequities, and assure adequate supplies to the consumers at the lowest reasonable price.

Senator NICKLES. Mr. Holland, thank you very much for your comments.

The next panelist is Richard Nelson, who is general manager for Natural Gas, Shell Oil Co., from Houston. Mr. Nelson.

STATEMENT OF RICHARD F. NELSON, GENERAL MANAGER, NATURAL GAS, SHELL OIL CO., HOUSTON, TX

Mr. NELSON. Good morning. I am Richard F. Nelson, general manager of natural gas for Shell Oil Co.

Others have and will tell you about the standoff between the interstate pipelines and the FERC on transportation, and you've heard and will hear about the flaws in the Commission's block billing proposal. These are very serious problems, and I disouss them at length in my full statement submitted to the subcommittee.

However, especially in view of the Department of Energy's recent proposal to FERC on old gas prices, I wish to emphasize, hear an alternative to block billing. This alternative can add to the Nation's energy resources; it can reduce the demand for foreign energy; it can help the U.S. balance of payments' problems; it can save consumers money; and it can even help reduce the Federal deficit. I've probably understated its benefits. [Laughter.]

There is no magical formula to do all these things. All that has to be done is to increase old gas to just and reasonable levels, something now approximating the market. Indeed, Mr. Chairman, Shell is very encouraged that the DOE earlier this week formally proposed to FERC that it use its authorities under the NGPA to establish just and reasonable prices for old gas.

Instead of acting on old gas, the Commission put out its revised block billing scheme, a false promise of an orderly gas market. It doesn't accomplish the goals of the Commission, and it perpetuates the market mess resulting from the over 30 categories of gas in the NGPA. It does send the country down another rabbit trail while we avoid the core problem.

On the other hand, if the Commission were to raise old gas prices, the existing inefficiencies and distortions in the market would disappear. Our statements here today might not make Senator Metzenbaum's day, but I hope they give him a happy coffee break. [Laughter.]

Now the bonus for the country is that reasonable prices for old gas would avoid the absolutely certain waste of gas in the old fields. This is gas which will not be produced at below-market regulated prices. We estimate that the volume of this additional gas which could be produced is in the range of 31 to 37 trillion cubic feet. That's a 2-year supply.

This gas is in known, developed fields. The investments have been made. It is already connected to the transportation network. It's part of the rate base. It's been paid for. To permit this gas and the connecting pipelines to be abandoned would be a national tragedy. Gas abandoned in the ground is just the same as gas flared. It's totally wasted. The unused pipelines would just rust away.

Now if old gas can be rescued from abandonment, we will also be less dependent on energy imports. A 1-to-1 Btu trade will save over $50 billion in the next 10 years in payments to foreign oil producers. Consumers will save over $25 billion by fully utilizing these existing transportation and distribution facilities; and the Government revenues will be enhanced by receiving royalty and taxes from additional domestic production.

For the last few years, the Commission has been reminded of the benefits of raising old gas prices, but it hasn't done it. If the FERC again fails to exercise the responsibility given it by the Congress, then the Congress must do the job itself. A good vehicle to decontrol old gas prices on a gradual basis is your bill, Mr. Chairman, S. 1302, now pending before this subcommittee. We support your bill.

S. 1302 and 436 are great numbers for the Nation's gas woes. Shell accepts the fact that the Commission's nondiscriminatory transportation program is voluntary. Pipelines can come to the party, or they can decline to as they choose. However, they can't have it both ways.

Shell has put its pipeline customers on notice that if they decide not to offer us a transportation alternative, they will have to live up to each and every provision of their sales contracts.

Summing up, the Commission has put in place the framework for a sensible transportation program, and we hope that the pipelines will soon come to see the benefits in that program. Now the Commission or the Congress must take the essential second step of allowing old gas prices to reach market clearing levels. Once that is done, we will have a rational and efficient gas market, and we'll avoid the tragic waste of an irreplaceable national asset, and we can replace the surplus shortage cycles of the past with adequate supplies of gas at reasonable prices.

[The prepared statement of Mr. Nelson follows:]

STATEMENT OF RICHARD F. NELSON
GENERAL MANAGER - NATURAL GAS
SHELL OIL COMPANY
BEFORE THE SUBCOMMITTEE ON
ENERGY REGULATION AND CONSERVATION
OF THE SENATE ENERGY COMMITTEE
NOVEMBER 21, 1985

My name is Richard F. Nelson. I am General Manager of Natural Gas for Shell Oil Company (Shell), and I am responsible for the marketing of natural gas by Shell and its affiliated companies in the United States.

I am pleased to share with you Shell's position on the Federal Energy Regulatory Commission (Commission) Order No. 436, issued October 9, 1985, at Docket No. RM85-1-000.

I

Shell's reaction to the Final Rule

Basically, Shell believes that the Commission has adopted a framework that, for the first time, would introduce meaningful competition into the gas industry. Some of the elements of the Final Rule which Shell supports include:

- Allowing transportation without regard for the category of gas, the source of gas, the identity of the shipper or the end use of the gas,

- Setting volumetric transportation rates to optimize use of the interstate pipeline systems,
- Unbundling transportation rates from rates for other services such as storage,
- Allowing negotiated rates to encourage competition between pipelines for transportation business,
- Recognizing that managements of pipelines and distributors should bear risks and obtain rewards for their decisions,
- Favoring negotiations between pipelines and producers to resolve contractual take-or-pay problems, without setting strict guidelines for their negotiations,
- Adopting a policy in favor of expeditious abandonment of gas which is not being taken by pipelines, and
- Establishing an alternate certificate procedure to further facilitate competition for both transportation and sales of gas.

Although Shell applauds most of the provisions of the Final Rule, it has, in the process of applying for rehearing of Order No. 436, pointed out some inequities in the Order. The most serious of these flaws is the granting to firm pipeline customers the dual authority to reduce firm contract demand of up to 25% per year (an abrogation of executed service agreements) and to convert the volume so reduced to firm, preferred transportation rights (an undue preference contrary to the principle of non-discrimination).

Perhaps as important as what the Commission did in the Final Rule is what it refused to do. On the positive side, the Commission declined to follow suggestions that it authorize pipelines to cancel contracts with producers and that it condition producer access to transportation only upon waiving contract rights such as take-or-pay. Had the Commission attempted either action, Shell is confident that the Commission would have been reversed in an appellate court.

On the other hand, while the defect was not apparent at the time Order No. 436 was issued, it now appears - a month and a half after that date - that the Commission was too quick to terminate existing transportation programs. Because of the reaction of pipelines to transportation under the Final Rule, which is discussed below, the Commission should have provided for a reasonable transitional period.

Pipeline reaction to the Final Rule

At least initially, the interstate pipelines have almost universally rejected the Commission's invitation to become competitive. Despite the pipelines' public stance that voluntary transportation is working and that mandatory carriage is not needed, when the Commission asked them to provide transportation service on a non-discriminatory basis, the pipelines refused.

One by one, pipelines have notified Shell that they will not become transporters under Order No. 436. The reasons given vary from company to company: they are still studying the Order; they are afraid of losing markets; they need clarifications; they didn't get what they asked for from the Commission; and so on.

Alibis aside, it is becoming clear that the interstate pipelines are quite content with their present position. They are able to exert near-monopsonistic power as purchasers and near-monopolistic powers as resellers. The pipelines have - and want to keep - absolute control over transportation access. Competition is a foreign concept to the pipelines, and they like it that way.

Yet, while the pipelines refuse to participate in the competitive arena, they also refuse to accept their role as gas merchants, responsible for buying from producers and providing secure service to distributors and users. In other words, the pipelines are refusing to live up to the contracts they signed. And we have seen no efforts by the pipelines to take advantage of the alternatives given them by the Commission in the Final Rule. These include the invitations to buy out or buy down their take-or-pay "problem" contracts and to offer producers release and abandonment of unneeded gas.

In the face of a united front by the pipelines, Shell has no choice but to insist on punctilious performance by pipelines under contracts. Shell takes this position with reluctance; it would much prefer to compete under the Commission's transportation program and to renegotiate contracts rather than litigate to enforce contracts. However, if the opportunity to have gas transported is denied Shell because of pipeline intransigence, Shell will not permit them to have the best of all worlds, with Shell and other producers bearing all market risks and guaranteeing pipeline profit margins.

Shell is also deeply concerned about the anticompetitive unanimity of the pipelines. We find it curious that not a single pipeline management has seen fit to file for a long-term blanket transportation certificate, to try take-or-pay buy-downs or to offer to help producers abandon sales.

The Commission versus the pipelines

In the face of virtually total rejection of Order No. 436 transportation, the Commission has adopted an equally hard line in defense of its Order.

Since October 9, when the Final Rule was issued, the Commission has put out a series of technical corrections and clarifications. In almost all cases, those orders narrowed the scope of lawful transportation which could be performed outside of the Final Rule after November 1. In addition, the Commission chose not to grant the requests of producers and marketers for short-term blanket transportation of higher-priced gas released from contracts for sale at market prices. Instead, it granted only the authority for limited-term abandonment and sales for resale, without giving any rights for essential transportation. In this case, half a loaf is not even a crumb.

We now have an impasse; pipelines will not play in the new game, and the Commission will not relax the rules. This test of wills would be interesting to watch except that the real losers in this contest are the producers denied access to markets and the consumers denied competitively-priced gas.

II

The Block Billing proposal

Order No. 436 did not issue the controversial - and much misunderstood - Block Billing proposal. Instead, the Commission clarified its earlier proposal and asked for additional comments on the revised billing procedure.

Shell is pleased that the Commission has clarified that Block Billing is literally that - a method of splitting customers' bills into two blocks. This is merely an after-the-fact notification of the relative volumes delivered from each block during the preceding month. It is now clear that a customer cannot designate volumes of gas to be delivered from a block and that a pipeline cannot call on producers to deliver gas preferentially from a block. Furthermore, the Block Billing proposal does not override state authority, either conservation and proration rules in producing states or the pricing jurisdiction of agencies in consuming states. And most importantly, the Commission has declared that Block Billing in no way authorizes pipelines to breach contracts with producers.

Thus, Block Billing is not a panacea for distributors, an escape hatch for pipelines, a disaster for industrial users or a road to ruin for producers.

Shell's position on Block Billing

Although Shell does not oppose Block Billing with the fervor seen in public statements by some producers, Shell certainly does not support it.

Essentially, Shell agrees with the Commission that there are serious flaws in the present billing system and there are inefficiencies and distortions in rolling in prices for controlled and decontrolled gas. Shell further agrees with the Commission's principles that proper pricing should promote efficiency in both production and consumption, should permit fair competition, should discourage waste and should accommodate changes in market conditions.

However, Shell unequivocally states that Block Billing will neither solve existing problems nor achieve the Commission's goals.

As long as there exists a system in which gas is half slave and half free, the basic distortions will continue. Historic customers will continue to have an advantage over new customers; users in regions endowed by historic accident with large supplies of old gas will have an edge over their competitors in less favored parts of the country served by pipelines with higher-priced gas; mixed, conflicting price signals will be sent to producers, continuing the tragic boom/bust cycles of supplies; and some 48 state regulatory agencies will still have the final say over how gas will be priced at the burnertip. These conditions will exist with or without Block Billing; the only change effected by Block Billing would be to rearrange the current advantages and disadvantages among consumers, distributors, pipelines and producers.

Block Billing has been touted by some observers (but not by the Commission) as a mechanism for the transfer of wealth from producers to consumers. Nothing could be farther from fact. Actually, as long as average wellhead prices are at market clearing levels, consumers, on average, will see no substantial changes in prices,,and the producing industry's revenue will be substantially the same.

The distribution of wealth under a Block Billing scheme, if one is to occur, will be among producers. Accordingly, there is no appreciable reason for the Commission to referee an intramural scuffle. The powerful forces of the marketplace - stronger than artificial billing rules - will control who wins and who loses. The power of market forces was recently demonstrated when the predicted "fly-up" became a "fly-down" on January 1, 1985.

III

The alternative to Block Billing

The Commission does have authority to cure the present ills in the industry and to reach its pricing objectives: it can increase old gas prices to just and reasonable levels. That authority was expressly given to the Commission in the Natural Gas Policy Act of 1978 (NGPA) as to gas covered by sections 104 (old interstate gas), 106 (rollover contracts) and 109 (other gas) of that statute.

If the distorting effects of permanently-regulated gas are removed from the market picture - rather than being hidden under a State regulatory agency's agenda - subsidies of one group for another will in turn disappear. Price parity will be available to all regions and all consumers; market pressures will cause too-high prices to come down; and correct signals will be exchanged between producers and consumers. In short, a free, unfettered and efficient gas market will develop.

Benefits of just and reasonable pricing

Not only will the gas market become rational if just and reasonable pricing is instituted, but the national interest will be enhanced by the production of gas from old fields which could not be economically recovered under unrealistic regulated ceiling prices.

Two years ago, Shell presented testimony to this Subcommittee. At that time, we introduced a study by Dr. C. S. Matthews, a Senior Petroleum Engineering Consultant for Shell, which indicated that approximately 52 trillion cubic feet of additional gas could be produced over time as a result of total gas decontrol. The rationale and methodology of that study has been accepted in principle by others, including the Office of Technology Assessment. While the numeric conclusions have differed from reviewer to reviewer, it is now widely accepted that old gas is responsive to price increases and that the response is significant.

Last September, Shell again testified before this Subcommittee. In connection with that appearance, we presented a similar study by Dr. Matthews to estimate how much old gas reserves would increase if S. 1302, a gradual decontrol bill, were enacted. The new study is attached as Appendix A.

I must point out that there is not equality between absolute deregulation and just and reasonable rates set by the Commission. Free market pricing has no floor and no ceiling; a just and reasonable rate is, in the words of the statute, a maximum lawful price. In addition, we would expect that an agency-set price would be fairly inflexible and probably tending to the low edge of reasonableness - if past Commission decisions are a guide. There is no real administrative substitute for true deregulation.

However, Dr. Matthews' study is cited to demonstrate the magnitude of additional reserves which could become available if the Commission were to exercise its authority to set just and reasonable rates which approximate commodity values.

Description of the reserves study

At an average market clearing price for gas over the next decade of $3.00 per MMBtu (in 1985 dollars), the study indicates that enactment of S. 1302 or comparable legislation would add between 31 and 37 trillion cubic feet to U.S. gas reserves. This is about two years' U.S. gas production. These reserves would be added in three ways. First, an increase in gas prices upon contract expiry would enable the lowering of abandonment pressure in old gas fields. At a higher gas price, the wells in those fields can be produced to a lower producing rate before revenue is equal to producing costs. Thus, the fields will reach lower abandonment pressures, which will result in additional gas' being recovered.

The second method by which reserves will be added by deregulation is due to additional well stimulation. Fracturing and acidizing of old wells opens new pay zones and enhances the contribution of zones of low productivity. At low, regulated gas prices, this stimulation is usually uneconomic and will not be carried out. However, as contracts expire and the prices for gas rise, many well stimulation treatments become profitable and will be undertaken.

We estimate that the combined effect of lowering of abandonment pressure and additional well stimulation due to deregulation on contract expiry could add from 20 to 26 trillion cubic feet to U.S. gas reserves at an average $3.00 per MMBtu market price.

The price currently allowed by the NGPA for new, onshore production wells ($3.05 per MMBtu) is about the same as our assumed average market clearing price over the next decade ($3.00). Thus, enactment of deregulation legislation will cause little or no additional development and infill drilling in old gas fields at this time. We should keep in mind, however, that the $3.05 NGPA price is frozen forever in real terms. Gradual deregulation will lead to additional infill drilling when gas prices rise above the $3.05 per MMBtu price (in 1985 dollars). Our $3.00 per MMBtu average price for the next decade assumes a price somewhat less than $3.00 for the initial five years and a somewhat greater price for the last five years. Thus, there would be a positive effect on infill drilling in the 1990's.

We have estimated in Appendix A that the potential reserves due to infill drilling at prices above $3.05 per MMBtu (in 1985 dollars) will be about 11 trillion cubic feet.

Thus, the total additional reserve additions due to enactment of a statute such as S. 1302 will range from 31 to 37 trillion cubic feet.

The 31 to 37 trillion cubic feet of gas to be recovered by freeing old gas from unrealistic pricing controls simply must be produced. If that gas is not produced, this invaluable domestic resource will be completely wasted - a tragedy to the national interest.

The economic benefits from just and reasonable pricing due to these additional recoveries of old gas reserves are documented in Appendix B. Those benefits are:

- The U. S. balance of trade would be improved by $50.5 billion (in 1984 dollars) over the next ten years due to reduced volumes of imports of alternate fuels.
- Non-switchable gas consumers would save $25.3 billion (in 1984 dollars) over the next twenty years by fully using existing transportation and distribution systems.
- Government revenues, both federal and state, would be enhanced by taxes and royalties on increased domestic production.
- More U. S. employment opportunities would be provided.

The anticipated knee-jerk reaction to increasing old gas prices is the old saw that consumer prices will go up. It may surprise you, but the contrary is true: average consumer payments for gas would not rise. The basic reasons for this are that average gas prices today are at market-clearing levels and that the old gas fields are already connected to the nation's pipeline system, with no new facilities being necessary to bring this over-30 trillion feet of additional gas to market.

Congress has repeatedly shown its concern for America's energy future. It has encouraged conservation of energy resources in enacting laws regarding such things as home insulation and gasoline mileage. Congress cannot sit idly by while an enormous volume of potentially producible gas is left in the ground due to administrative inaction. If the Commission again refuses to exercise its prerogatives to let old gas be produced, Congress must act.

Gas surpluses and shortages

Let us not be deluded by today's "bubble" of surplus gas deliverability. The gas from those old fields will be needed! Frankly, the NGPA has not worked to elicit necessary gas reserves. Despite claims of future abundance, one fact cannot be denied: there are less lower-48 gas reserves today than when the NGPA was enacted. And the situation is getting worse. All we have to do is observe today's moribund drilling rates to see that 1985 reserve additions will not replace current production - which has not even occurred during years of heavy drilling activity.

The bubble will burst, and the cycle of shortage and surplus, each caused by shifts in federal regulatory policy, will continue.

Conclusion

I cannot simply come here and testify about the Commission's Order No. 436 and talk about regulatory alternatives.

I must remind this Subcommittee that there is but one final solution to this nation's recurring natural gas problems: full, complete and total deregulation of all gas as soon as possible.

APPENDIX A

Increase in U.S. "Old Gas" Reserves
Due to Enactment of S. 1302

The treatment here follows that given in the April 1983 study entitled "Increase in United States 'Old Gas' Reserves Due to Deregulation," by C. S. Matthews, Shell Oil Company. That study was submitted in April 1983 to the U.S. House of Representatives Subcommittee on Fossil and Synthetic Fuels of the Committee on Energy and Commerce.

In the April 1983 report, we estimated that reserves of old gas in the lower 48 states which would respond to deregulation were about 115 Tcf as of January 1, 1981. At that time we included 30.8 Tcf of intrastate gas in the 115 Tcf. We did this because, even after the so-called deregulation of much of intrastate gas on January 1, 1985, an additional price limit was placed on this deregulated gas. In our April 1983 study this price limit was less than our assumed market clearing price. Thus, this gas was really not price deregulated under those market conditions.

Under current market conditions, we find that the price limit placed on this deregulated intrastate gas is greater than the current market clearing price. Thus, we should subtract from 115 Tcf, the reserves of intrastate gas which were deregulated on January 1, 1985. We estimate that about 73 percent of intrastate gas was deregulated at that time. Therefore, we subtract .73 (30.8) = 22.5 Tcf from 115 Tcf and obtain 92.5 Tcf as the base responsive to decontrol.

The calculations shown in Table 1 of the cited report are now repeated for a deregulated price over the next decade of $3.00 per MMBtu. This leads to an increase in reserves due to lower abandonment pressure for the 14 fields in Table 1 of 9 Tcf. We scale this up to the total U.S. by multiplying by 92.5/41.3 where 41.3 is the reserve for the 14 fields and 92.5 is the total responsive reserve base of old gas in the United States as of January 1, 1981. This gives 20 Tcf as the estimated increase in old gas reserves due to lower abandonment pressure at the $3.00 per MMBtu price.

We estimate the increase in reserves due to fracturing and acidizing as 1.5 percent of ultimate as discussed on page 18 of the cited report. For the response base of 92.5 Tcf, the ultimate is 92.5 (475)/115 = 382 Tcf. Thus, the fracturing and acidizing increase is 0.015 (382) = 6 Tcf.

The total possible response is 20 + 6 = 26 Tcf.

In applying these calculations to S. 1302, we estimate that about 10 percent of old gas contracts with expiry dates will expire each year. S. 1302 also contemplates relief for those contracts which will not expire soon enough to achieve deregulated price relief -- even those contracts having a term for the life of the lease or the reserves. Proposed section (f)(2) would allow the parties to renegotiate contracts to bilaterally increase price to levels sufficient to continue economic production. Thus, within the next decade nearly all old gas contracts will expire or can be renegotiated to continue economic production. In this time frame, we estimate that no significant number of fields will be abandoned. Although some wells in a field may be abandoned, the remainder still producing at contract expiry can be produced to the new lower reservoir abandonment pressure and thereby increase gas recovery from these fields. The maximum increase for the U.S. is estimated above to be 20 Tcf.

Fracturing and acidizing would also be undertaken on contract expiry. In addition to enhancing productivity of old wells, this in many cases would open new pay zones and increase production from low productivity layers. This would lead to the estimated 1.5 percent increase in ultimate production from the wells (6 Tcf). As some wells will be abandoned before contract expiry, the 6 Tcf should be viewed as a maximum.

In summary, we estimate that the combined effect of lowering of abandonment pressure and additional well stimulation due to enactment of S. 1302 will increase U.S. "old gas" reserves by 20 to 26 Tcf.

Thus far we have not have not addressed infill drilling. Enactment of S. 1302 would not lead to additional infill drilling at this time. This is because the current price allowed by the NGPA for regulated onshore infill wells ($3.02 per MMBtu) is about the same as our assumed market clearing price over the next decade ($3.00 per MMBtu in 1985 dollars). However, we must keep in mind that the NGPA price of $3.02 is frozen forever in real terms. It rises only with inflation. Thus, enactment of S. 1302 would have a positive effect on infill drilling when gas prices rise above $3.02 per MMBtu (in 1985 dollars). Our $3.00 per MMBtu average price for the next decade assumes a price somewhat less than $3.00 for the initial five years and somewhat greater for the last five years. Thus, S. 1302 would have a positive effect on infill drilling in the 1990's.

To estimate how much such infilling would add to "old gas" reserves, we refer to the section on infill drilling in our cited April 1983 report. Because additional infill drilling would not occur for some time, we eliminated fields where the gas reserve was less than 20 percent of ultimate recovery in 1981. This eliminated Puckett, Carthage, Kettleman Hills and Rio Vista. We also eliminated the high-cost infill fields, Bayou Sale, Bastian Bay, Katy and Old Ocean reasoning that infilling would only occur well into the future. By so doing we eliminate 18 percent of the infill potential of the Analog Fields in Table 1.

Our previously-calculated infill reserve addition for the total U.S. was 18 Tcf, using a response base of 115 Tcf. For our revised response base of 92.5 Tcf, the potential U.S. reserve additions are 14.5 Tcf. If we assume for reasons stated above that we will obtain only 82 percent of this potential, our estimate becomes 12 Tcf.

Of this 12 Tcf potential, infill wells not drilled on acreage committed or dedicated to interstate commerce on April 20, 1977 where either decontrolled on January 1, 1985 or will be decontrolled on July 1, 1987. We can estimate the magnitude of this from information in Table 12 of "U.S. Crude Oil and Natural Gas Reserves," 1977 Annual Report by the U.S.

Department of Energy. That Table indicates that about 5 percent of gas reserves in the lower 48 states were not committed as of December 31, 1977. Thus, 5 percent should be subtracted from the 12 Tcf potential due to decontrol in the above-mentioned categories. This brings our final estimate to 11 Tcf due to additional infilling brought about by S. 1302.

Thus, the total potential reserve additions due to the enactment of S. 1302 are 31 to 37 Tcf.

APPENDIX B

ECONOMIC BENEFITS FROM "JUST AND REASONABLE" PRICES FOR ADDITIONAL RECOVERY OF OLD GAS RESERVES

CONCLUSIONS

- Improves U.S. balance of trade by $50.5 billion (1984 dollars) over the next 10 years due to reduced volumes of alternate fuel imports.
- Non switchable gas consumers would save $25.3 billion (1984 dollars) by fully utilizing the existing transportation and distribution systems over the next 20 years.
- Provides opportunities for higher government revenues in the form of royalties and taxes.
- Provides domestic employment opportunities.

Discussion

The initial assumption in this analysis is that the additional gas recovery documented in C. S. Matthews' study* is assumed to come gradually to market. The loss of these gas reserves will require substitution by alternate fuels. The current alternatives to domestic natural gas are imported fuels or domestic coal. The following analysis compares the cost of imported fuels as they are substituted for old gas production which is abandoned due to uneconomic gas prices. While it was assumed that the 31-37 TCF additional reserves estimated by the Matthews' study would translate into available production over a 20-year period, we have based our primary calculations of imported fuel substitution on a conservative 10-year period. Beginning in the mid-1990's domestic coal could be an alternative to domestic natural gas.

Raising the price of old gas to "just and reasonable" levels that will allow the additional recovery of old reserves as discussed in C.S. Matthews' study will provide significant economic benefits to the U.S. public. Money spent domestically instead of abroad results in higher government revenues from state and federal royalties, severance taxes, and income taxes. Additionally, money spent domestically increases domestic employment opportunities.

* Refer to C. S. Matthews' study in appendix to D. G. Russell's Senate testimony September 19, 1985.

Because it is assumed that natural gas will continue to compete with alternate fuels at the burner tip, switchable consumers will experience no increased direct costs as fuels are substituted. However, the fixed cost of the natural gas transportation and distribution systems is incorporated into the systems' cost of service and allocated on a throughput basis. Consequently, reduced throughputs will result in an increased unit charge to the non switchable customers.

It might be argued that imports of Canadian gas could be substituted for the old gas reserves and use the existing transportation and distribution network. However, Canadian flow routes are significantly different from those of the old gas which are presently connected and flowing. For Canadian gas to replace fully our estimated 1.7 TCF/yr. of old gas would require significant expansions of the existing transmission system. The costs of these expansions ultimately fall on the natural gas consuming public.

ANALYSIS

Cost Of Imports

Assumptions

- If prices are not raised to just and reasonable levels, 31-37 TCF (use 34) are not recovered over the next 20 years.
- 34 TCF ÷ 20 years = 1.7 TCF/Yr. incremental volume.
- The natural gas burnertip price equilibrates with the delivered residual fuel oil price.
- GNP deflators, conversion factors, future crude and residual fuel oil prices are based on DRI's forecast of September 4, 1985.

Calculations

- Residual fuel price (gas equivalent basis) x 1.7 TCF/Yr. x 10 Yrs.
  = $50.5 Billion (1984$) Cost of Imports

Cost To Consumers of Under Utilized Transportation

Assumptions

- Transportation and distribution cost is the difference between the burnertip price and the natural gas wellhead price.

- The fixed cost of the transportation and distribution system is estimated at 80%. Thus, the cost to be borne by the consumer is the difference between residual fuel at the burnertip and wellhead gas multiplied by 80% (or less the 20% variable cost).

- The natural gas wellhead price forecast is based on DRI's average Lower-48 price for gas.

Calculations

First 10 years

- Gas wellhead price x 1.7 TCF/Yr. x 10 Yrs. = $34.1 Billion (1984$)

- Cost of residual fuel at the burnertip less gas wellhead price = $50.5 - $34.1 = $16.4 Billion

- ($50.5 Billion - 34.1 Billion) x 80% = $13.1 Billion Net Cost to Consumers

Second 10 years

- Although domestic alternate fuels, rather than imported residual fuel oil, may be substituted for additional old gas recovery, the transportation fixed cost would continue to be recovered with less throughput.

- Another Potential $12.2 Billion Cost to Consumers

Senator NICKLES. Mr. Nelson, thank you very much.

Our next panelist is Ted Eck, chief economist for Amoco from Chicago. Mr. Eck.

STATEMENT OF THEODORE R. ECK, CHIEF ECONOMIST, AMOCO CORP., CHICAGO, IL

Mr. ECK. I would like to, in the interests of time, confine my remarks to what's happened since the last time we talked about gas before this committee.

First, the order No. 436, certainly the move toward open transportation, is positive. Very positive, the decision of postponed block billing. But as an economist, I was particularly interested in the release of exhibit S, which explains the rationale for block billing. It's clear that a faulty decision was made by the Commission based on a faulty staff study.

I have very carefully gone through exhibit S, and it's very evident this is a technically unsound study. It's contradictory and just not consistent with the way gas is produced and sold today. I think the underlying misconception is that we can convert the natural gas industry into a giant spot market. This just won't work.

I am confident that the testimony given before this committee and before the Commission will convince the Commission to abandon block billing.

I would next like to take just a minute to address recent developments in gas markets, developments since the last time we met, and to emphasize first that the market indeed is working. Natural gas prices are coming down not only in the spot markets, but the average price of natural gas in the field has come down substantially in the last 6 months.

We've also had particularly rapid reductions in 107, section 107 gas, or the so-called high-cost gas. You can see that the price of this gas has come down from a high of around $7.50 to something a little over $4 today. So clearly the contract renegotiation process is working, and these gas prices are coming down.

Further evidence of how the market is working is gained by review of the actual purchased gas costs of the major pipelines. Here we see over the last 2 years there have been very impressive reductions indeed in these purchased gas costs. This explains the interest in moving forward with contract carriage and assuring that the benefits that the pipeline has received in terms of much lower acquisition costs flow through to the final market to homeowner and other users.

I would next like to cite briefly the take-or-pay issue, and state first of all that to the best of my knowledge this is the first time I have agreed with Senator Metzenbaum before this committee on a major gas and oil issue. Indeed, he is absolutely right. The take-or-pay is a phony issue. It is being used by the pipelines as a shield to hide behind full participation in contract carriage.

Let's bear in mind that these are the same corporations that told us before January 1 of this year that unless something was done to change contracts, given take-or-pay, that we're going to have a giant flyup in gas prices as a consequence of decontrol. And of course they were 100 percent wrong. Prices in the field for natural gas went down with decontrol, despite contracts and despite some limited efforts in the contract carriage area.

Indeed, I think it's important to contrast the story of the pipelines before committees, before all of us in Washington here, on how bad the take-or-pay issue is versus what they're telling Wall Street about very good earnings, and indeed who does Wall Street believe? They believe the story in New York, not the story here in Washington. I am confident that we're going to make progress on this take-or-pay and continued renegotiation will take place.

I would also like to comment very briefly on the DOE's recent proposals to increase the maximum lawful price for old gas. This is clearly a very constructive approach. But I would like to emphasize that the thrust of this proposal is to increase the maximum lawful prices subject—subject to existing contracts. That's been our position all along: That there's just no authority for FERC or any other body to abrogate existing contracts, and that this movement must take place within existing established contract procedures.

I would finally like to address the issue of where we go from here. First of all, what FERC should do.

FERC should reject block billing as soon as possible. Clearly the pipelines are using the block billing as an excuse for not proceeding more rapidly with contract carriage, and as a consequence we should immediately remove that excuse and get rid of block billing.

Probably we should do something with the 25-percent rule, which was referred to earlier. We testified that that was a bad procedure and a bad idea. It's proving to be a bad idea and should be dropped.

Probably we'll need some extensions of these 45-day periods to encourage the process of getting started with contract carriage. Maybe more section 7 certificates. Maybe we need to address the tariff structures themselves and provide more incentives to the pipelines to indeed improve and increase the utilization of their facilities.

Finally, I am confident that the producers are going to make every effort possible to make sure that 436 transportation provisions work. Ten days ago we announced, as the major signatory to a very large contract renegotiation with Columbia Gas that settled a great deal of take-or-pay, our basic intention to do whatever we can to make this thing work. Indeed, we have already settled over $1 billion of take-or-pay settlements on our efforts to make sure that transportation—make sure that markets work.

What should this committee do? I think this committee needs to very carefully monitor the progress of FERC in implementing 436; provide encouragement for these suggestions that I have made; and finally, to encourage the FERC to very carefully consider the thoughtful ideas of DOE on increasing the maximum lawful price for old gas; to have hearings on this subject; and proceed with this legal authority that they have.

Thank you.

[The prepared statement of Mr. Eck follows:]

TESTIMONY ON THE FEDERAL ENERGY REGULATORY COMMISSION'S BLOCK-BILLING PROPOSAL FOR NATURAL GAS

BY

THEODORE R. ECK
CHIEF ECONOMIST
AMOCO CORPORATION

Introduction

Attached is a copy of the submission that Amoco made to the Federal Energy Regulatory Commission (FERC) on November 18, 1985, on block-billing. We urge your Committee to ask FERC not to implement the block-billing proposal which runs the risk of undermining the benefits of open transportation. Essentially all segments of the natural gas industry (producers, pipelines, many distributors, and most industrial consumers) agree that block-billing is not needed. Amoco's testimony explains why block-billing would be illegal and detrimental to both consumers and producers, and why it would not achieve FERC's purported goals.

Some organizations have been urging forced modification of existing producer-pipeline contracts in order to make FERC Order 436 work. This is not necessary. High-priced natural gas contracts are being voluntarily renegotiated and the High Cost Gas prices have been coming down. Amoco strongly opposes the forced modification of existing contracts.

Amoco has concern with the fact that U.S. natural gas proved reserves have fallen from 16 years supply in 1967 to about 8 years of supply at current production rates. The industry has failed to replace production with new natural gas reserve additions in 18 of the last 20 years. The rig count is off 60 percent--from a peak of 4,500 in 1981 to 1,900 currently. These trends should alarm everyone concerned with future U.S. natural gas supplies.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas)
Pipelines After Partial)
Wellhead Decontrol)

Docket No. RM85-1-000
(Part D)

COMMENTS OF
AMOCO PRODUCTION COMPANY

I. EXECUTIVE SUMMARY

Order No. 436 will result in major changes to the gas industry, but it will take some time before all the effects are known. Fortunately, the Commission delayed implementation of block billing and reissued it for comments. After closely analyzing the revised block-billing proposal, Amoco is convinced that block billing is bad policy for consumers, pipelines, and producers. Not only is it unlawful and unnecessary, especially with the new open transportation rules, but it will inhibit the effectiveness of those rules in achieving what Amoco believes is the Commission's fundamental goal -- creating more flexibility for gas consumers, transporters, and producers.

Amoco believes that block billing exceeds the Commission's statutory authority and is therefore unlawful. Amoco is not alone in reaching this conclusion; many others in all segments of the gas industry have also formulated extensive legal arguments that reach this same conclusion. Amoco has joined in the legal analysis provided by the Indicated Producers and has provided additional comments on that topic in Appendix A hereto. Thus far the Commission has dismissed these arguments, and Amoco can only conclude that the Commission seems willing to risk the inevitable court review that would follow the implementation of block billing, which would be a serious mistake.

If the Commission does not now reject the block billing proposal, the several years that will likely pass pending judicial review while the issue of block billing remains unresolved will cast a cloud of uncertainty over much of the industry. More importantly, if block billing is finally found to be illegal, great damage will be done by the enormous costs and hardships in restoring the _status quo ante_. Amoco believes the Commission will make a serious mistake if it fails to fully respect the compelling legal arguments that have been assembled by Amoco and others. As a minimum, the Commission should provide a full response to the legal arguments that have been made against the Commission's block billing proposal.

Block billing cannot accomplish anything that is not already taking place in the natural gas markets, but it certainly can cause many problems. Gas prices, both on the spot market and under long-term contracts have been coming down. The average gas price is already below the competitive oil price. High-priced gas contracts are being renegotiated, as evidenced by the fact that the average price of High-Cost Gas (NGPA Section 107) has been declining (Exhibit 1). Also, the weighted average cost of gas (WACOG) for pipelines has been decreasing (Exhibit 2). Amoco is unaware of any contracts for new gas being signed at above market prices as a result of the old gas cushion.

The lack of transportation opportunities has been the industry's problem and the Commission has already addressed that with Order No. 436. Block billing is a flawed concept designed to solve problems of a bygone era, *i.e.*, an era of curtailments and shortages when gas was viewed as a precious fuel in limited supply. Block billing, if implemented, will artificially exaggerate price pressures and likely lead to future natural gas shortages. The Commission incorrectly blames rolled-in pricing for the high prices that were locked into contracts. Today, wellhead gas prices are declining and no pipeline pays above market prices for new purchases of gas.

Even without block billing, the long-term U.S. natural gas supply outlook is unfavorable. The current gas surplus or "bubble" is largely illusory. The gas industry has not replaced gas production with new proved reserve additions in 18 out of the last 20 years and reserves are at the lowest level since World War II. Wellhead gas prices have been declining throughout 1985, and so has the search for new gas supplies (*e.g.*, the rig count has declined from nearly 2,700 in January to 1,900 rigs currently, a 30 percent decline in only 10 months). It would be a misguided policy to impose a regulatory system that would artificially force down wellhead gas prices (and the search for new gas supplies) even faster than market forces dictate.

If block billing works as the Commission intends, Block 2 gas prices could fall from the current average price at the wellhead of about $3.70 per Mcf to $2.60 per Mcf, lowering the average wellhead price for Block 1 and 2 gas from the current $2.60 to $2.00 per Mcf, and siphon off $6 billion per year from exploration and development, about half the industry's entire expenditures for gas drilling in 1984. A program that could lead to siphoning off that enormous amount of money from an industry that is already operating at a level of the late 1970's (when shortages and curtailments were present) makes no sense.

Even in the short term, a decrease in Block 2 gas prices will help consumers little while causing a great deal of harm to future gas supplies. Burner-tip price reductions will depend on how much of the wellhead price decrease for Block 2 gas is passed on to final consumers. The study released by the Natural Gas Supply Association (NGSA) on the financial performance of interstate pipelines 1/, for example, shows that pipeline margins have grown enormously as a result of regulated low wellhead gas prices. Further, the data on page 112 of the American Gas Association 1984 Gas Facts publication shows that over the period 1974 to 1984, combined transmission and distribution margins increased from $0.65 to $2.50 per Mcf, an increase of

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1/ A copy of the Executive Summary from that 400-page study is attached hereto as Appendix B. The entire report is available from the Natural Gas Supply Association (of which Amoco is a member).

$1.85 per Mcf. From this, it is not hard to see that much of the decrease in wellhead prices for Block 2 gas is likely to wind up in the pipelines' growing margins, instead of going to the consumer.

Most government, industry, and other U.S. gas supply forecasts project that domestic gas production will not be able to keep pace with demand in the 1990's, and that gas imports will have to be increased sharply to meet domestic demand, even without block billing.

Amoco projects that natural gas imports will triple from 1 Tcf in 1985 to 3 Tcf in 2000 because of decreased U.S. production capability even without block billing. With block billing, natural gas imports will have to increase from 1 Tcf in 1985 to 6 Tcf in 2000 in order to meet domestic gas requirements. That large an amount of imported gas is not expected to be available at marketable prices and instead oil imports will have to increase by about 1.5 million barrels per day by 2000 to offset the shortage of domestic natural gas production.

Oil imports currently cost the United States $50 billion per year and make up nearly half of the U.S. merchandise trade deficit. Even without block billing, the cost of oil imports would be expected to increase to about $100 billion in 2000 in constant 1985 dollars. Increasing imports by an additional 1.5 million barrels per day in 2000 because of block billing would increase the import bill in the year 2000 to $135 billion (in 1985 dollars) and further increase our dependence on undependable Middle East oil supplies.

Amoco urges the Commission not to implement the block billing proposal because block billing is illegal, unneeded, and detrimental to consumers, pipelines, and producers. If the Commission really wants to help consumers by assuring adequate long-term gas supplies at just and reasonable prices, then it should raise the old gas ceiling prices to a just and reasonable level.

II. COMMENTS

A. Rolled-in Pricing Was Not The Problem

The Commission, throughout the revised block-billing proposal, blames rolled-in pricing as the major cause of industry's past and present distortions.

On page 6 of Part D, the Commission states:

> "The Commission proposed Part D because it appeared from our review of the NOI comments and the experience since enactment of the NGPA that full rolled-in pricing has significantly contributed to the wide swings from gas shortages in the 1970s to surplus in the early 1980s."

The shortages of the 1970's were caused by two decades of wellhead gas price controls at unrealistically low levels. The Commission's predecessor, the Federal Power Commission (FPC), eventually recognized this when it started raising gas ceiling prices in the early 1970's, and Congress recognized it when it passed the NGPA. These low ceiling prices had a devastating impact on natural gas reserve additions, which for a number of years were only equal to about half the gas production. The gas reserves that were added were mostly the result of the higher incentive prices in the deregulated intrastate market, and, as a result, there were no shortages in the intrastate markets.

Like interstate pipelines, intrastate pipelines bought gas at varying contract prices (depending on the market conditions under which the individual contract was signed) and resold the gas at a rolled-in price, yet there were not shortages in the intrastate market. So, to blame the shortages of the 1970's in the interstate market on rolled-in pricing (when the culprit was artificially low regulated gas prices) is simply wrong. Block billing, built upon this incorrect analysis by the Commission, is thus fundamentally flawed.

The Commission is also wrong in asserting that rolled-in pricing "contributed significantly" to the surplus of the early 1980's. The primary reason for the gas surplus of the 1980's was the belief by many that gas and oil prices would continue increasing in the foreseeable future and that gas was a precious fuel in limited supply. Aggravating the surplus was the lower U.S. and worldwide economic activity in the early 1980's as well as conservation resulting from higher prices, which lowered world and U.S. oil and gas demand. To ignore these factors and imply that rolled-in pricing was the major cause of the current gas oversupply situation is again simply wrong.

Similarly, the "boom-and-bust" example for gas (described in pages 41 to 43 and in Table D-2 in the Notice, reproduced here in Exhibit 5) actually paralleled the rise and fall of world oil prices.

There was no rolled-in pricing for world oil prices, yet the boom-and-bust cycle of oil is virtually identical to that for gas. The drilling boom in the early 1970's through 1981 occurred because of increasing world oil prices and, more importantly, the perception of increasing future oil prices. The bust came when world oil prices began to decline beginning in 1981.

The Commission in its block billing proposal implies that the pipelines in the environment of gas shortages of the 1979-80 period, used their old gas cushion to bid up (against each other) the price of decontrolled high-cost gas. If indeed that is correct, the pipeline with the greatest old gas cushion should have paid the highest prices and acquired the largest amounts of decontrolled high-cost gas. The Department of Energy's 1982 and 1984 analyses 2/ of the actual data concluded that this is not what actually happened.

DOE's analyses concluded that the pipelines that purchased the high-cost gas most aggressively were the ones that most needed new gas supplies, and not the ones with the biggest old gas cushions. By contrast, many pipelines with the largest old gas cushions had the least need for new gas supplies, and were among the least aggressive in their high-cost gas purchases. The Commission should reflect upon DOE's studies in its review of block billing, for they clearly show that the facts do not fit the justification for block billing given in the Commission's proposal.

2/ U.S. Department of Energy, An Analysis of Post-NGPA Interstate Pipelines Wellhead Purchases, Part III. September 1982 (DOE/EIA-0357). U.S. Department of Energy, Recent Market Activities of Major Interstate Pipeline Companies, January 1984 (DOE/EIA-0400).

B. Rolled-In Pricing Will Not Be A Problem In The Future

The Commission, in trying to justify the need for block billing, argues as if the bidding up of decontrolled gas prices (that it wrongly attributed to rolled-in pricing) still exists and that rolled-in pricing remains a problem. Assuming, arguendo, that rolled-in pricing caused a bidding up of decontrolled gas prices, there has not been such a bidding up of prices for some time and there is no expectation in the foreseeable future that purchasers will pay above market prices for new gas supplies. Simply put, the problem the Commission is proposing to solve with block billing does not now exist.

The old gas cushion is simply no longer a factor in the gas market. This was confirmed by the fact that gas prices, instead of flying-up at the time of partial NGPA price decontrol on January 1, 1985, have declined. The Commission will recall that many companies and organizations, including the Interstate Natural Gas Association of America (INGAA), 3/ were issuing studies and press releases about the big price fly-up that was going to occur on January 1, 1985. Claims were made that it was absolutely essential that action be taken to modify gas purchase contracts to prevent this from happening (in spite of producers' claims to the contrary). No fly-up occurred; yet some of these same organizations, unembarrassed about being wrong, now are predicting that gas purchase contracts must be modi-

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3/ See, for example, the April, 1984 study issued by the Interstate Natural Gas Association of America's Policy Analysis Department entitled "Analysis of Price Fly-Up Under The Natural Gas Policy Act."

fied to make Order No. 436 work. Amoco urges the Commission to examine the past track record of those predicting price increases in the absence of Commission action, and refrain from implementing its block billing proposal.

Amoco is unaware of any new contracts being signed at above market clearing prices, regardless of how much old gas the pipelines have in their systems. Prices for new long-term contracts have been declining and appear to be at or below the average wellhead price of $2.60 per Mcf. The spot price has also been declining and is around $2 per Mcf. In virtually every market, the delivered price of gas on a Btu equivalent basis is at or below the residual fuel price, its primary competitor in the industrial market, and far below heating oil, its competitor in the residential/commercial markets.

In view of this environment, the Commission has no basis to assert in its Notice that:

> "One has only to reflect on the disparity between prices for gas being brought to market for direct sales to customers, and the prices for otherwise identical supplies that are to be rolled-in with old gas in pipelines' system supply. The rolled-in price is expected to compete against the direct sale price, yet the incremental supplies contracted for by the pipeline will necessarily have to carry a higher price since they are averaged with price-controlled, old gas." 4/

Amoco is unaware of any pipeline that is contracting for any new gas supplies at prices higher than that paid by a direct sales customer on a similar contractual basis (length of contract, firmness of supplies, etc.). There may be some price differences because direct sales customers generally are willing to take the risks of

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4/ 50 Fed. Reg. at 42376.

spot market purchases whereas the pipelines have large firm demands to meet and tend to rely more on long-term contracts. Obviously, these differences have nothing to do with old gas cushions.

The higher prices the Commission is referring to are due to the fact that some of the pipelines' existing contracts have higher prices than the prices currently paid for new gas supplies. However, this is the nature of long-term contracts and the inevitable contract price disparities which occur with changing market conditions, and is certainly not unique to the gas industry (*e.g.*, the banking industry when interest rates change significantly). With controls on part of the gas and long-term contracts in place, some gas will continue to be sold at prices below the average and some at prices above the average price. To claim rolled-in pricing causes these differences and that block billing will largely eliminate them is simply wrong.

The second sentence of the Commission's above-quoted excerpt is puzzling. Therein the Commission states, "incremental supplies contracted for by the pipeline will necessarily have to carry a higher price since they are averaged with the price-controlled, old gas." The Commission makes this statement without substantiating it. Amoco sees no reason why pipelines would pay more than the direct sales customers for new gas supplies when there is not a shortage of gas. It would not be logical in the present market to pay above market prices for gas just because it can be blended in with lower-priced gas, and the Commission's statement is simply incorrect.

The Commission further claims that:

> "Rolled-in pricing provides disincentives to producers to bring new supplies into those markets where cushions of old gas are not available to subsidize the production of that new gas. Thus, the supply of gas for direct sale to customers by producers or to spot markets is artificially constrained since producers would thereby forego the opportunity to receive a subsidy from a pipeline cushion of old gas. Eliminating rolled-in pricing would bring forth greater supplies in those markets." 5/

Even assuming that the Commission's old-gas-cushion/price-run-up hypothesis is correct (the above analysis has shown it is not), the above assertion is still not valid. Amoco cannot envision a producer deliberately withholding gas from a market just because it does not receive a subsidy, especially in the present gas surplus environment. To the contrary, gas producers have been the leading proponents of open transportation so that they could sell gas directly to exactly those markets which the Commission claims producers would be reluctant to sell to with rolled-in pricing. The Commission's above assertion is totally contradicted by the evidence in the actual marketplace and is just another of the many incorrect assertions upon which the Commission has built its block billing case.

C. Block Billing Will Decrease U.S. Natural Gas Production

The Commission's comments accompanying the revised block-billing proposal indicate clearly its intent to force down gas prices. The only uncertainty in this respect expressed by the Commission is the extent to which Block 2 prices will decline. Amoco estimates the current average price for industry Block 2 gas at about $3.70 per Mcf

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5/ Ibid.

and the total U.S. Block 2 production at around 5 Tcf annually. The wellhead market-clearing price for new long-term contracts appears to be around $2.60 per Mcf. The present wellhead spot market price of gas is approximately $2.00 per Mcf.

The Commission considers it is unrealistic to assume that Block 2 prices will fall to the spot price level since "the Commission considers spot prices -- the riskiest form of gas sales of all, from the buyer's standpoint -- to be the low end of the range of likely Block 2 prices resulting from block billing."6/ However, even if one assumes that Block 2 prices would fall only to the new contract price level of about $2.60 per Mcf (a $0.60 per Mcf premium above the spot price), the loss of revenues for gas producers would still be a decrease of $1.10 per Mcf on 5 Tcf or about $6 billion per year.

Not only is block billing expected to bring down the current Block 2 price, it may even depress new gas contract prices because of increased takes of Block 1 gas at the expense of other gas (Block 2). Block 1 takes are likely to increase with block billing since with increased difficulties in marketing Block 2 gas during the transition period, the pipelines will seek to maintain throughputs by increasing their block 1 takes.

As will be explained in a later section, gas demand is unlikely to increase in the short term as a result of block billing even with lower average gas prices to consumers. In fact, it is likely that gas demand in the short term will decrease with block billing.

6/ 50 Fed. Reg. at 42383.

Combining lower overall near-term demand with higher takes of Block 1 gas, block billing would put enormous short-term downward pressure on new gas prices.

The $6 billion revenue loss for gas producers does not include any revenue loss as a result of new gas prices themselves being depressed by the effects of block billing, and thus could be a conservative estimate. Even then, the $6 billion per year loss in revenue would be equivalent to about one-half of the gas drilling expenditures in 1984. Such a reduction in industry revenues would substantially reduce drilling, future gas discoveries, and production.

Some commenters and the Commission apparently believe that producer revenues are not relevant to the level of exploration and production (E&P) expenditures. This belief is based on the assumption that if the incentive price for gas is high enough, funds will flow to the gas industry from outside sources in the form of bank loans, drilling funds, etc. While theoretically appealing, the analysis below shows this assumption is simply not true. Both incentive prices as well as revenues determine the future level of drilling activity. As shown in Exhibit 3, industry E&P expenditures are highly correlated with industry revenues. Historically, over the long run, 80 to 90 percent of industry expenditures have come from internally generated funds.

It is true that immediately after the second OPEC oil price increase in 1979-80, significant external funds entered the industry because of the widespread expectation that oil prices would increase dramatically, but that was a rare exception in the history of the industry. In recent years, funds have been flowing out of the industry due to restructuring in response to already depressed oil and gas prices. As a result, debt has replaced equity and the debt to equity ratio for the petroleum industry is at a record level.

Banks, after having been badly burned on many energy loans, are reluctant to make new energy loans. Tax and Commission regulation uncertainties also make banks hesitant about lending funds for energy projects. These factors rule out bank loans as a large source of additional funds for the petroleum industry. In addition, many drilling funds, which acquired oil and gas properties at inflated prices a few years ago, are having problems. As a result, drilling funds are unlikely to be a significant source of external funds for the industry for the foreseeable future.

In short, the petroleum industry will have to rely on internally generated funds for finding and developing oil and gas in the U.S. Taking $6 billion of revenues annually away from the industry at this juncture (when drilling is already in a depressed state) would be catastrophic for all segments of the gas industry, including the drilling service industry.

Reduced internally generated financial resources and the decreased incentive price (new contract price) will diminish industry access to external capital because of lower coverage of fixed obligations and generally poorer financial conditions and prospects. Not only will total financial resources be reduced, but operators will become more selective in allocating their diminished cash to available drilling prospects. Only the highest return prospects with fast payouts will be drilled.

Even if one believes that reducing producer revenues by $6 billion per year and depressing new contract prices would benefit consumers in the short run, and that, contrary to the past, the artificial low wellhead prices will be passed on, consumers will pay a high price in the long run. It is precisely this kind of short-sighted thinking that created gas shortages in the 1970's and led to sharp gas price increases. Amoco estimates that implementation of block billing would reduce U.S. gas production in the year 2000 by an additional 2 Tcf over and above the 2 Tcf per year decline Amoco projects without block billing.

The Commission in its Notice argues that although gas prices will drop in the short run, prices will rise if shortages threaten to develop (giving increased incentive to gas producers to increase production). Therefore, the Commission concludes that block billing would not cause shortages. The Commission fails to recognize, however, that oil and gas production cannot be turned on and off like a faucet. There are long lead times involved, especially in the areas that are most promising for major new reserve additions like the deep-water offshore where an increasing percent of future gas production will have to come from. Once drilling supply companies go bankrupt, rigs are scrapped, geologists and engineers are lost to other professions and new ones not trained, there will be a long lead time to resume increased drilling activity. These practical, real-world considerations have been omitted from the Commission's analysis, and this is the reason for the Commission's incorrect assertion that block billing will not cause shortages.

At present there is a surplus of gas and consumers are benefiting in terms of declining gas prices. Open transportation will increase the competitive price pressures at all levels in the system to the benefit of consumers. The gas surplus peaked in 1983, has been declining and will continue to decline until supply and demand are in balance. Imposition of block billing at this stage would artificially exaggerate the price pressures and rapidly transform the gas surplus into a gas shortage. Thus, contrary to what the Commission claims, "boom and bust" cycles would be created by block billing, and not reduced by this policy.

Consumers should not be subjected to another round of shortages and rapid price escalation while the Commission is experimenting with a new theory on regulation. That theory, as set forth in Exhibit S of the Notice, 7/ is not only devoid of real world practicalities, but is flawed in concept, as the economists' comments attached to the NGSA and the Indicated Producers' submissions show. To go forward with a program flawed in theory and devoid of the real world practicalities of the gas industry is irresponsible.

7/ 50 Fed. Reg. 42395-42406.

D. Block Billing May Not Increase Short-Term Gas Demand, But Will Increase Long-Term Demand

The Commission implies that the reduced price of Block 2 gas (as a result of block billing) would stimulate gas demand, reduce the current gas bubble and thus benefit producers by increasing sales. Amoco contends that block billing is more likely to reduce than increase gas demand in the short run. However, it is likely to increase gas demand in the long run, but that demand increase is expected to increase only gas and oil imports, as explained later.

First, the Commission assumes that the reduced Block 2 wellhead gas price will be passed on entirely to the final consumers at the burner-tip. It is more likely, however, that allocation of the benefits of the lower-price Block 1 gas and any reduction in Block 2 gas prices would become a political issue at the state and state Public Utility Commission (PUC) level. Some states, seeing gas prices going down, may use it as an opportunity to raise gas taxes for generating needed revenues. Other states may allocate the benefits to residential customers, where demand is least price sensitive.

Second, consumer gas purchasing decisions are based on their marginal price for gas, which under rolled-in pricing is the same as their average price (currently about $2.60 per Mcf netted back to the wellhead on a national basis). Under block billing, some state PUCs may direct their local distribution companies (LDCs) to pass along Block 1 and Block 2 prices separately to the final individual consumers or groups of consumers (residential, industrial, etc.).

Other PUCs, even with block billing, may allow their LDCs to continue the current practice of rolling-in Blocks 1 and 2 gas for resale to the final consumers.

Where LDCs sell gas to final consumers separately in Blocks 1 and 2, the marginal price to consumers would be the Block 2 price. The Block 2 price initially would be near $3.70 per Mcf on a national average basis. Thus, with the implementation of block billing, the marginal price of gas to consumers would increase from $2.60 to $3.70 per Mcf, not down. Later, as the price of Block 2 gas declines due to competition, it might settle at approximately the $2.60 per Mcf level, the current rolled-in price. Therefore, the gas consumption would be lower in the short run and about the same in the long run compared to consumption in the absence of block billing.

Where the LDCs continue to roll-in Blocks 1 and 2 gas for resale to final consumers, initially the marginal price to consumers would continue to be the average rolled-in price of $2.60 per Mcf. As Block 2 prices come down, the final consumers may begin seeing the lower average/marginal price (assuming it is passed through, not absorbed by increased distributor margins). The resulting increased demand would take even longer to materialize since users' consumption patterns have long lead times. For example, even with lower marginal prices, consumers are not going to remove insulation or replace the new more efficient furnaces they put in to replace the old inefficient ones. New construction will continue to be better insulated and equipped with the more efficient furnaces. Thus, any large increase in gas demand in this case will occur in the long run and not in the short run.

Therefore, in the short run, block billing will lower the gas demand in the first case and keep it essentially unchanged in the second case. In the long run, block billing will keep gas demand unchanged in the first case and increase it in the second case. With block billing some PUCs are likely to continue permitting rolled-in pricing at the LDC level, others may not. Therefore, on the whole, block billing will lower the gas demand in the short run and increase it in the long run. Amoco estimates that block billing will increase long-term demand by about 1 Tcf per year in the year 2000 compared to demand without block billing.

Most present forecasts show long-term U.S. gas production declining and imports increasing even without block billing. With block billing, domestic gas production is expected to decline even faster. A long-term increase in demand for gas will thus only increase energy imports.

The Commission implies that with lower gas prices, industrial fuel users will switch from alternate fuels to gas, thus increasing demand. 8/ However, the only fuel that gas can realistically expect to displace is residual fuel oil, since displacing coal or nuclear energy for electricity generation is not economical and gas is already far below the cost of heating oil. Residual fuel oil has already been displaced to about the maximum extent possible by gas

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8/ 50 Fed. Reg. at 42383.

and coal. U.S. demand for residual fuel oil has fallen from 3 million B/D in 1978 to about 1 million B/D in 1985 (Exhibit 4). The current level of residual fuel oil use is primarily the amount needed for applications like bunker fuel, captive refinery fuel, etc., where gas use is not practical.

Some of this displacement of residual fuel oil by gas had been facilitated by recent experimental transportation programs, which have now been replaced by the Order No. 436 voluntary transportation program. To the extent block billing makes pipelines reluctant to participate in the new program, residual fuel oil will recapture some of these markets from gas.

Thus, contrary to the Commission's claim, block billing will not increase U.S. gas consumption in the short term, and thus will not increase U.S. gas production. If anything, it would decrease consumption in the short run. Block billing would only increase long term gas and oil imports.

E. Block Billing Will Increase Oil Imports And Worsen The Balance Of Payment Problem

Even without block billing, U.S. natural gas imports are expected to increase from 1 Tcf in 1985 to about 3 Tcf in 2000, as shown in the following table:

Without Block Billing

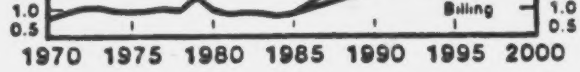
	TCF	
	1985	2000
U.S. Dry Gas Production	17	15
Imports	1	3
U.S. Gas Consumption	18	18

As explained earlier, if block billing is implemented, domestic natural gas production is expected to be 2 Tcf lower in the year 2000 than without block billing and potential U.S. gas consumption is projected to be 1 Tcf higher, requiring 6 Tcf of imports as shown in the following table and graph:

With Block Billing

	TCF	
	1985	2000
U.S. Dry Gas Production	17	13
Imports	1	6
U.S. Gas Consumption	18	19

U.S. Natural Gas Imports



It is not clear where 6 Tcf of imports would come from. It is doubtful if Canada can supply more than 2 Tcf. Perhaps Mexico and other sources could supply another 1 Tcf. The remaining 3 Tcf of natural gas demand would have to be satisfied by residual fuel oil, which would mean 1.5 million B/D of additional oil imports. Even without the imposition of block billing, U.S. oil imports are expected to increase from 5 million B/D in 1985 to 9 million B/D in the year 2000.

The contribution of oil imports to the U.S. trade deficit is projected to double in 1985 constant dollars from $50 billion in 1985 to $100 billion in 2000. The additional 1.5 million B/D of oil imports in 2000 from block billing would increase imports to over 50 percent of oil consumption and increase U.S. vulnerability to unstable Middle East oil supplies while raising the trade deficit to $135 billion (in constant 1985 dollars). Including normal inflationary increases in crude oil prices, the total oil import bill would increase to $300 billion in 2000. The Commission must consider the larger economic implications of block billing and weigh the possible benefits against the detriments. Subjecting the U.S. economy to an enormously expanded trade deficit in an attempt to impose a "level playing field" on natural gas pipelines is an unacceptable risk.

F. Block Billing Will Create Distrust For Government Incentives and Long-Term Contracts

The intent of block billing is to lower Block 2 gas prices under long-term contracts. Most of these contracts were based on the incentives created by Congress in the NGPA and implemented by the Commission itself. For instance, the Commission under the NGPA created incentive prices for tight-sands gas at 200 percent of Section 103 ceiling prices. Gas producers made substantial investments to find and develop gas in response to these incentives, and signed contracts to sell that gas. Block billing is designed to force the price in such contracts down faster than would occur in the give-and-take negotiations of the marketplace.

If the Commission implements block billing, gas producers in the future will demand risk premiums in the form of higher gas prices before making investments. The higher prices will be necessary to compensate for the risk of future rulemakings that threaten valid contracts. In effect, the cost of capital and the prospective return to potential investors will have to increase to compensate for additional commercial risks imposed by block billing.

An obvious additional result is that long-term contracts will become much less prevalent. In a world with far fewer long-term contracts, future gas revenues will be much less reliable. The resulting higher financial risks would increase the cost of both external and internal capital, and reduce the capital available for drilling at any given level of gas prices.

Also, with a move to fewer long-term contracts,producers will concentrate on shorter payout investments. Longer lead-time projects, where the potential for large future gas supplies is the greatest, will be de-emphasized and future gas production will suffer. Pipeline financing, where banks demand long-term contracts to minimize the default risk, will become difficult to obtain. Consumers desiring long-term contracts for assurance of supply will find this option is largely gone. Those who need a dependable long-term energy source will be forced to look to other fuels.

G. Block Billing Will Increase, Not Decrease, Distortions

The Commission's claim that block billing will help "level the playing field" for pipelines is totally unsubstantiated. Gas producers and pipelines have been voluntarily renegotiating contracts and, as a result, pipelines' rolled-in gas prices have been coming closer together. This process is expected to accelerate with open transportation. Despite years of claims about the disastrous take-or-pay claims that the pipelines face, pipeline company annual reports never mention these problems. Indeed, the pipelines have prospered in recent years under the NGPA, as the Foster Associates pipelines financial performance study for NGSA clearly shows. 9/

9/ A copy of the Executive Summary from that 400-page study is included as Appendix B. The entire report is available from the Natural Gas Supply Association (of which Amoco is a member).

At best, block billing will merely shift market distortions down to the state PUC level. We will have 48 different state PUCs trying to solve the problem (instead of one FERC solving it) with each having its own solution. As mentioned earlier, some PUCs may tilt the benefits of the cheaper Block 1 gas in favor of residential customers. In other cases, state legislators may use up the cushion of the lower Block 1 gas price by increasing natural gas taxes to raise tax revenues. That will increase the national as well as region-to-region distortions, not lessen them.

As described earlier, any cushion that was there has long ago been eliminated by falling oil prices and higher priced post-NGPA gas. At present, the rolled-in average wellhead price is about $2.60 per Mcf. Adding about $1.00 per Mcf for transportation, the delivered gas price for industrial users is about $3.60 per Mcf. This is already at or below the current price for residual fuel oil (its primary competitor) on a delivered Btu equivalent basis. Thus, the cushion is essentially gone, contrary to the Commission's assertion.

To the contrary, block billing will recreate the cushion at the LDC level if, according to the Commission, the Block 2 price comes down, _e.g._ if the price comes down from $3.70 to the estimated current new contract price of $2.60 per Mcf. If the current practice of rolled-in pricing at the LDC level continues, the rolled-in price of $1.50 per Mcf for Block 1 gas and $2.60 per Mcf for Block 2 gas would be about $2.00 per Mcf, at least $0.60 per Mcf lower than the wellhead price required to be competitive with the delivered residual fuel oil price.

Thus, not only would LDCs be able to phase down contractual gas purchase volumes from their pipeline suppliers using the 25 percent rule, but (according to the Commission's own "bid-up hypothesis) the $0.60 per Mcf cushion provided by block billing would allow LDCs to outbid pipelines for new gas supplies when a gas supply tightness develops. With block billing, this tightness of supply can be expected to happen, and probably quite quickly. Similarly, LDCs with larger volumes of Block 1 gas would be able to outbid those with lower volumes of Block 1 gas, creating new market distortions at the LDC level.

III. CONCLUSION

Wellhead gas prices have been declining throughout 1985 and drilling activity has fallen sharply from nearly 2,700 rigs in January to 1,900 rigs currently, a 30 percent decline in only 10 months. There is simply no need to impose a regulatory system that would seek to artificially force wellhead prices down even faster than market forces dictate. Thus, there is no need for block billing.

Not only will there be a long period of uncertainty in the industry as block billing is being litigated, but if it is eventually found to be illegal, and Amoco and many others are certain that this will be the outcome, there will be enormous costs and hardships to roll things back to where they were.

Finally, the above economic analysis clearly demonstrates that block billing will be detrimental to both consumers and producers, and will not achieve the goals the Commission has set out to accomplish. Amoco hopes the Commission will see that block billing is indeed unlawful, unneeded, and harmful to the industry and consumers, and not implement this program.

Respectfully submitted,

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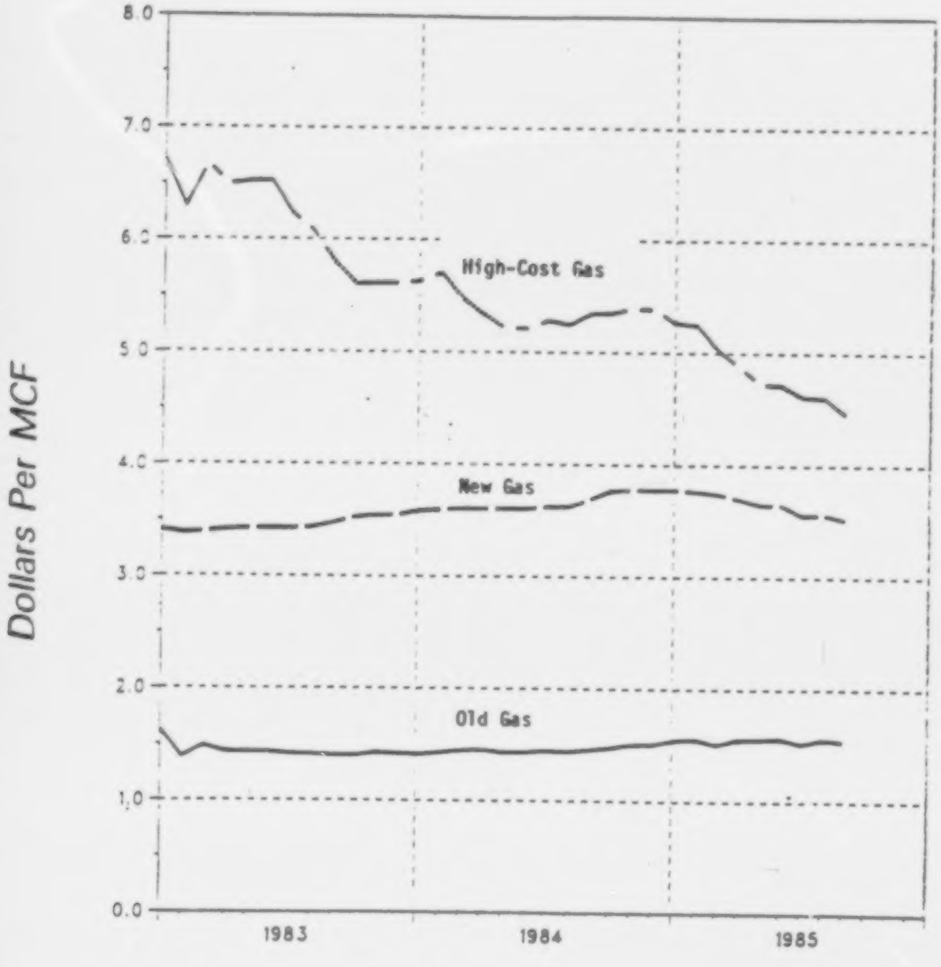
November 18, 1985

XHIBIT 1

PURCHASE GAS WELLHEAD PRICES



Source: DOE/EIA Natural Gas Monthly; August, 1985

EXHIBIT 2

COMPARISON OF WEIGHTED AVERAGE
PURCHASED GAS COSTS (WACOG) FOR SELECTED PIPELINES

	$/Million BTU		
Pipeline	1983 WACOG	1985 WACOG	Percent Change
ANR Pipeline	$3.20	2.44	-24
Columbia Gas Transmission Company	3.70	3.08	-17
Northern Natural Gas Pipeline	2.64	2.40	-9
Natural Gas Pipeline Company	2.55	2.46	-4
Panhandle Eastern	3.26	2.35	-28
Tennessee Gas Pipeline	3.21	3.18	-1
Texas Eastern	2.84	2.46	-13
Transwestern Pipeline Company	2.84	2.60	-8
Trunkline Gas Company	3.83	2.84	-26
Transcontinental Gas Pipeline	3.35	3.01	-10
United Gas Pipe Line Company	3.26	2.53	-22

Source: Foster Associates, "Current Purchased Gas Costs of Interstate Pipeline Companies," October 23, 1985, and Natural Gas Supply Association (NGSA).

EXHIBIT 3

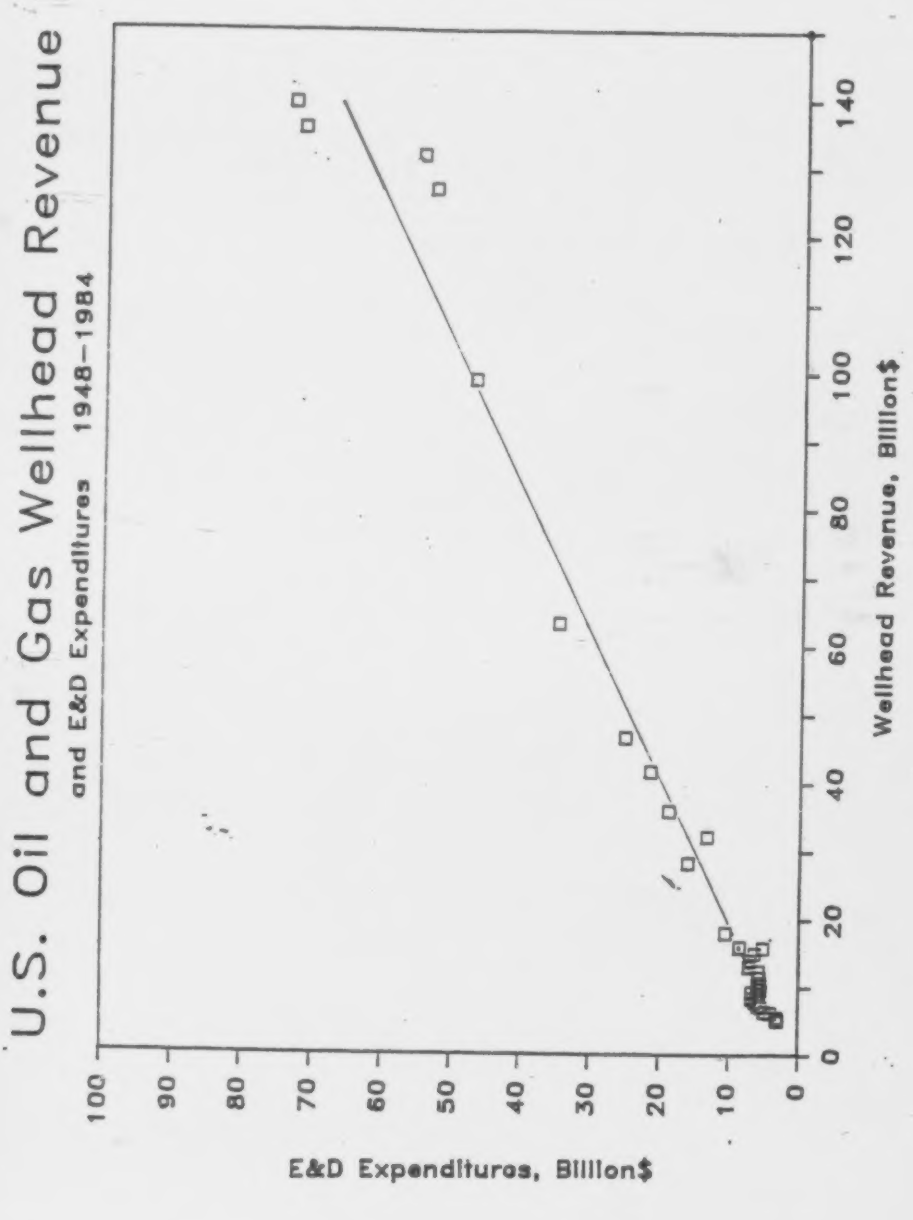

U.S. Oil and Gas Wellhead Revenue
and E&D Expenditures 1948–1984
E&D Expenditures, Billion$
100
90
80
70
60
50
40
30
20
10
0
Wellhead Revenue, Billion$
0
20
40
60
80
100
120
140

EXHIBIT 4

U.S. Residual Fuel Oil Sales

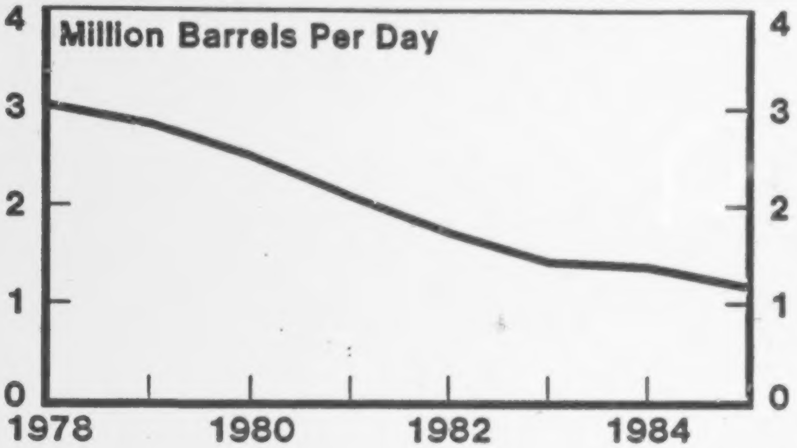


EXHIBIT 5

Table D-2

Selected Statistics on Natural Gas Production

SELECTED STATISTICS ON NATURAL GAS PRODUCTION

Year		Rig Count [a]		Average Gas Drilling Ave. Cost per Gas Foot [b]	Percent of Gas Wells High-Cost (107) [c]	Percent of Total Gas Production High-Cost (107) [h]	Price Paid for High-Cost (107) [d]	Average Wellhead price [e]
1975		1660		46.23/Mcf	--	--	--	$ .45/Mcf
1976		1658		49.78	--	--	--	.58
1977	B	2001	B	57.57	1%	--	--	.79
1978	O	2259	O	68.37	5%	NA	--	.91
1979	O	2177	O	80.66	7%	NA	--	1.18
1980	M	2909	M	95.16	8%	NA	--	1.59
1981		3970		122.17	9%	2.1%	$6.58/Mcf	1.98
1982		3105		146.20	12%	4.2%	$7.31	2.46
1983	B	2232	B	108.37	NA	6.2%	6.25	2.59
1984	U	2428	U	97.5 g	NA	5.7%	5.37	2.60
1985(8 Mos.)	S	2011 (8)	S	NA	--		4.98(6)	2.64(3)
	T		T					

Sources and Notes:

a. U.S. Energy Information Administration, Annual Energy Review: 1984, DOE/EIA-0384 (84), Table 31, Page 1969. Data for 1985 from Hughes Tool Company release, "Rotary Rigs Running By States, August 1985".

b. American Petroleum Institute, Joint Association Survey on Drilling Costs (Annual Reports 1975-1983). 1984 data based upon information from IPAA indicating that drilling costs in 1984 decreased about 9 percent with a sharper decrease in gas than oil.

c. U.S. Energy Information Administration, Drilling and Production Title 1 of the Natural Gas Policy Act, DOE/EIA-0448, June 1984, Figure 17, page 55.

d. U.S. Energy Information Administration, Natural Gas Monthly, May 1985, DOE/EIA-0130 (85/05), Table 5, page 12.

e. Ibid. Table 4, page 10..

f. While the NGPA was enacted in late 1978, its price provisions were made retroactive to April 1977. (See EIA, Drilling and Production ... (op. cit.) page vii).

g. Estimate based on data from IPAA showing a 9% decrease in all drilling cost, with a steeper reduction in gas costs than oil costs.

h. Based on projected volumes and prices reported in PGA filings.

Appendix A

Supplemental Legal Comments

Amoco has joined with the Indicated Producers in an extensive review of the Commission's lack of authority under the NGA and NGPA to implement block billing. Amoco hereby adopts *mutatis mutandis* the legal analysis put forward by the Indicated Producers. In addition to the extensive legal analysis of the Indicated Producers, Amoco wishes to articulate two additional points on the legality of block billing which the Commission must consider.

1. The Title II Incremental Pricing Provisions of the NGPA Indicate Congress' Intent to Preempt the Commission's Freedom To Radically Depart From the NGPA's Cost Allocation Structure.

Where the Congress intended different treatment of certain types of gas consumers regarding allocation of gas costs under the various NGPA categories, it spoke; where it intended no distinction, it made none. In the NGPA, Title II incremental pricing is the only such differentiation among customers established by Congress and, in Title II of the NGPA, Congress defined those categories of customers who were to be treated differently. However, the NGPA Title II consumers subject to incremental pricing bear no resemblance to Block 2 customers as defined in the Commission October 9 block billing notice.

Indeed, the NOPR can be characterized as creating an illegal additional tier of incremental pricing not provided for in the NGPA.

The two underlying objectives of the Commission's block billing proposal are: (1) to mitigate perceived market distortions created by pipelines with large cushions of old gas bidding up the price of new supplies (*i.e.*, the level playing field rationale); and, (2) to retain the benefits of old gas pricing for a certain preferred class of customers. These objectives bear a striking resemblance to the objectives Congress sought to achieve under NGPA Title II:

> A. *Objectives of Title II Incremental Pricing*. Title II of the NGPA, the incremental pricing provisions, were included by the Congress for two reasons. First, incremental pricing is designed to mitigate any disruption of the natural gas market that might occur upon deregulation in 1985. Many members of Congress, particularly those opposing sudden deregulation, feared serious disruption if deregulation were to occur during a period of supply and demand imbalance. The relatively low price of gas remaining under controls after 1984 was seen as providing a effective "subsidy" to pipelines willing to pay higher than long-run market clearing prices for deregulated supplies. *Congress sought to eliminate this possible incentive for interstate pipelines to bid excessively* high prices by initially increasing the price of gas delivered to large, price sensitive industrial customers to a level equal to the cost of their alternative fuel. Under this regime, Congress anticipated that pipelines, whose revenues depend upon volumetric throughput, would seek to minimize further increases in the cost of gas that might occur upon deregulation, for fear that industrial demand for natural gas (and therefore throughput revenues) would decline.

> A second purpose of the incremental pricing provisions of the NGPA is to shield high priority gas users, such as residential users, from some of the scheduled wellhead price increases allowed by Title I of the Act. This shielding effect is accomplished by channeling to industrial customers a greater than pro rata share of rising prices paid by pipelines. The increased recovery of costs from industrial users results in a offsetting reduction in gas costs recovered from high priority users.1/ (emphasis supplied)

Furthermore, the Commission has specifically recognized that NGPA Title II dictates the basic structure of cost allocation to pipeline customers.

> The Commission accepts the need to provide proper price signals to gas users. However, the Commission notes that as long as gas prices are cost-based and reflect average ("rolled-in") historical costs of old contracts with low prices, the prices yielded by such a regulatory practice will not reflect the commodity value of the gas and, therefore, the price signals will not reflect the "true" value of the gas to society. *More particularly, the Congress has explicitly made the fundamental social policy decision to redesign the system by which gas costs, in the past*, have been allocated among user classes. 2/ (emphasis supplied)
>
> Title II will, by design, produce results that are more favorable to some classes of users. *But the Congress apparently weighed these*

1/ Order No. 80, FERC Stat. & Reg. ¶ 30,157 at 31,059-31,060 (1980).

2/ *Id.* at 31,085.

> inequities against the advantages of an incentive wellhead pricing system in Title I of the NGPA 3/ (emphasis supplied)

In discussing "structural aspects of the NGPA" the Commission has specifically recognized that the concept of rolled in pricing is essentially inherent in the NGPA: Finally, the NGPA at least permits, if not prescribes, so called rolled-in pricing with only insignificant limits 4/(emphasis supplied).

2. The Commission is not free to alter a previously established regulatory practice in use at the time of the NGPA was passed unless clear authority is provided for such change.

Rolled-in pricing of purchased gas was, prior to enactment of NGPA, "the only method . . . with which Congress was likely to have been familiar."5/ Indeed, the block billing proposal resembles in striking fashion the action which the Commission took in Order No. 93 *et seq*. in defining Btu's under the NGPA. However, the D.C. Circuit in INGAA v. FERC, *supra*, has clearly stated that the Commission cannot attempt to alter a historical practice in the absence of a clear indication in the NGPA itself that Congress intended such alteration. In INGAA, the Court reversed the Commission's interpretation in Order No. 93, *et. seq*. that Congress had shifted from the well known historical

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3/ *Id*. at 31,086-31,087.

4/ FERC Stat. & Reg. ¶ 30,336 at 30,105 (1982).

5/ Interstate Natural Gas Association of America v. FERC, 716 F.2d 1, 12 (D.C. Cir. 1983).

"wet" basis for measuring Btu's to an imputed "dry" basis. With respect to its block billing proposal, the Commission assumes, without any support in the legislative history of the NGPA and in contravention of historic rolled-in pricing practices, that Congress must have intended the NGPA to allow selective application of NGPA pricing categories to certain pipeline customers in order to preserve "economic rents" for such customers.

It is indisputable that in passing the NGPA, Congress recognized that rolled-in pricing was the traditional ratemaking method for pipeline sales. At Section 208 of the NGPA, Congress required that the cost of Alaskan gas:

> shall be allocated to the rates and charges of such interstate pipeline in accordance with the general principles applicable on the date of the enactment of this Act for establishing rates in connection with the issuing of certificates under the Natural Gas Act of interstate pipelines. (Emphasis supplied.)

In the 1978 Joint Explanatory Statement of the Committee On Conference regarding NGPA Section 208, the Conference Committee clearly stated that the "general principles" mentioned above refer to rolled-in pricing:

> The conferees agreed to provide rolled in pricing for natural gas transported through the Alaska Natural Gas Transportation System. (Emphasis supplied.)

Thus, there can be no doubt that the NGPA was enacted on the assumption and understanding that rolled-in pricing was the "general principle" on which pipeline resale rates were established. A departure therefrom cannot be within the bounds of the NGPA unless Congress specifically provided for such a departure or granted the Commission specific authority to effectuate such a departure. No such authority was granted to the Commission.

The INGAA case stands for the proposition that a departure from a general principle or accepted Commission practice cannot be tolerated where Congress itself assumed that that principle or practice would continue and enacted the NGPA on the basis of that assumption and understanding.

The specificity with which Congress instructed the Commission to administer pipeline resales via Title II belies any argument that something as revolutionary as block billing was intended by Congress or within the authority granted the Commission under the NGPA. The very existence of Title II incremental pricing is a strong indication that this section of the NGPA was the exclusive method for segregating pipeline customers for different rate treatment, and that Congress intended no other customer segregation for purposes of allocating gas costs other than what is provided for in Title II.

Appendix B

EXECUTIVE SUMMARY

Economic Performance of Major Interstate Pipelines

I. Introduction

In April 1985, the Natural Gas Supply Association (NGSA) contracted Foster Associates, Inc. (FA) to analyze the financial performance of 25 major interstate gas pipelines selected primarily on the basis of their gas purchases from producers.

Financial data for the interstate operations of the major pipelines are unavailable from Annual Reports to Stockholders (or similar public documents) because such reports reflect the totality of the parent companies' diversified operations, not merely their gas transmission activities. The only publicly available financial information on their pipeline operations is information supplied to the Federal Energy Regulatory Commission (FERC) in an annual report referred to as the FERC Form 2. In that report, audited by recognized public accounting firms, the pipelines provide complete financial data on their gas utility operations.

Therefore, FA was requested to compile the FERC Form 2 data in a consistent, technically sound manner to obtain an accurate portrayal of the actual financial performance of twenty-five selected major interstate pipelines over the period 1977-1984.[1] All allocations necessary to reflect the pipeline segment of the business were made by the pipelines in their reports to the FERC.

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[1] The FA Report covers the period 1977-1984. Beginning in 1977, the pipeline companies were required to specifically report in the FERC Form 2 the cost rates for short and long term debt and preferred stock associated with their gas pipeline business. These data are unavailable prior to 1977. Therefore, to avoid any arbitrary assumptions regarding the cost rates of senior capital, the FA study covers the period 1977 through 1984.

II. Summary of Results

The following discussion highlights the findings of the four hundred page FA study, focusing only on the aggregate results for the twenty-five pipeline composite group, not on the results for individual pipelines.

A. Pipeline Profitability

As shown by the table below, over the last five years the pipelines have enjoyed unusually high rates of return on total capital and common equity for a regulated utility.

	1980-84 Average Return on Investment	
	Total Capital	Common Equity
Gas Pipelines	13.1%	15.3%
Industrial Companies	12.1%	13.1%

For reference and to provide perspective on the level of the pipelines' earnings, the average returns achieved by industrial companies (an average for 900 large companies compiled by FA from data supplied by Value Line) are also shown. It is the Subcommittee's opinion that the large group of competitive industrial companies are, on average, exposed to higher business risks than are the regulated interstate pipelines, and, therefore, should command a higher return to compensate for the greater risk.[2] However, instead, as shown, the pipelines have achieved significantly higher returns, and the differential appears to have increased in recent years. For example, in 1984 the twenty-five pipelines achieved an average return on common equity of 16.9 percent versus 13.7 for the Value Line 900 industrial group.

The above data reflects the return for the composite pipeline group. Attachment I lists the 25 pipelines included in the study, and the return on average common equity for each company over the period 1977-1984. The bottom portion of the attachment shows the average and median return for the 25 pipelines. Also shown is the median authorized rate of return for the pipeline composite.[3] As shown, the actual return is always higher than the authorized returns, and usually by a substantial amount. Attachment 2 sets forth the pipelines' returns on total capital (rate base). The results are analogous to those on common equity.

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[2] An example of this greater risk is the fact that each year a number of industrial companies fail and go out of business while this would be a rarity in the regulated pipeline business.

[3] Since an authorized return for many of the pipelines is not available for every year, the median is a more meaningful measure of the central tendency.

The actual return on investment developed by FA was generally much higher than the FERC authorized rates of return for most pipelines. FA was asked to reconcile, or otherwise explain this apparent aberration. The Foster supplemental analysis (included as an appendix in the final report) concluded that the report accurately portrayed the actual financial performance of the pipelines, but that the actual rates of returns reported in the study are not directly comparable with the FERC authorized rates of returns because: (1) the FERC Form 2 financial data include the income and investment in nonjurisdictional utility operations; (2) the FERC authorized rate of return is based on a forward-looking test year, not on actual returns (recoveries in later rate cases are forbidden since it would constitute retroactive rate making); and (3) the final rate decision is usually a compromise that winds up focusing on the allowed revenues and tariff levels exclusively, with an authorized rate of return on rate base generally only available implicitly, or if provided, only to rationalize the settlement agreement.

B. Pipeline Margins

The FA report also contains a substantial body of information regarding pipeline margins, i.e., how much they add to the delivered cost of gas. This data was summarized in two forms: one, which develops the margin per unit of gas delivered by the pipeline, and a second, which calculates the margin per unit of gas delivered to end users. The two measures of pipeline margins were developed because pipelines purchase gas from each other as well as from producers. Consequently, there is a pyramiding of transportation costs, i.e., a pipeline's purchased gas cost includes payments to producers, and also payments to other pipelines for gas as well as for transportation. Stated another way, the volume of gas actually delivered to ultimate consumers of gas is far less than the total of the volumes handled by the individual pipelines. Because of this phenomena, the indicated margin per unit of total combined deliveries significantly understates the unit cost that pipelines actually add to delivered costs to the consumer.

The study shows that pipeline earnings are an important factor in the price consumers pay for gas, as can be seen from the data below, using 1984 as an example:

	1984 Earnings Contributions To Consumer Prices, $/MCF Based on:	
	Sales to End Users	Total Deliveries
Net Operating Earnings	.33	.16
Income Taxes	.22	.11
Total	.55	.27

The first column shows that the pipelines' net operating earnings (including the income taxes these earnings generated) added 55¢/MCF to the cost of gas paid by end users. This amounts to 11 percent of the delivered cost of gas to end users.

The second column shows the same data based on total deliveries by the pipelines. As discussed earlier, the much smaller values result from the fact that the denominator used (total deliveries) include the deliveries from one pipeline to another, not just deliveries to end users.

The common misconception that pipeline earnings are not a significant factor in delivered gas costs comes from the fact that from an individual pipeline perspective, the cost per MCF will be on the total delivery basis shown above. Furthermore, the income taxes necessary to generate these earnings are usually not considered. Consequently, an erroneous conclusion is reached that pipeline earnings add only 16 cents per MCF to delivered gas costs or about three percent. The study correctly shows that pipeline earnings, including taxes, actually add 55 cents per MCF (or 11 percent) and are an important component of delivered gas costs.

Another misconception regarding gas costs is that the only source for meaningful relief on consumer prices is at the wellhead, since transmission costs are too small to have a material impact on the end user prices. The study corrects this misconception. For example, in 1984 pipeline costs accounted for $1.64 per MCF, or about one third of the price paid by gas consumers:

	Pipeline Costs $/MCF Based on:	
	Sales to End Users	Total Deliveries
1984	$ 1.64	$ 0.80
1977	0.77	0.43

The costs are much higher when correctly viewed from the gas going to end users, instead of the unit costs that result from dividing by total deliveries, which is the only perspective available from an individual pipeline. As shown, not only are the pipelines' costs very large, but they have grown enormously over the period, more than doubling since 1977; increasing from $0.77 to $1.64 per MCF.

Some erroneously attribute the increase in pipeline margins to rising gas costs, since gas is used for compressor fuel. However, the rise in the cost of compressor fuel does not explain the increase in margins. Compressor fuel represents a relatively small portion of pipeline costs; in 1984, for example, compressor fuel costs accounted for only $0.11 of the $1.64 per MCF pipeline margin. If compressor fuel costs were eliminated from both the 1977 and the 1984 pipeline costs per MCF, the remaining costs still more than doubled, increasing from $0.74 to $1.53 per MCF. In contrast, the inflation over this same period was only 59 percent.

The large increase in pipeline margins confirms what economic theory would predict will happen when one cost component (wellhead gas prices) of a product is held at an artificially low price, several levels from the ultimate consumer. Since end user prices would then not be constrained by competitive market forces, the downstream costs would inflate to fill the cost vacuum created. In theory, the overseeing regulatory agencies should prevent this, but since regulation is cost based, the focus of the companies will be on cost justification, not cost minimization. Unconstrained by competitive market forces, and with the pipelines focusing on cost justification, costs can be expected to rise rapidly, which the study shows indeed did happen.

C. Pipeline Investment

Over the 1977-1984 period, pipeline sales to end users declined by approximately 7 percent. In such a period of declining volume, it would generally be expected that there would be little need for substantial new pipeline investments, absent major shifts in supply sources and/or consuming centers. Due to the increase in accumulated depreciation charges over time, it would be expected that the pipelines net depreciated investment would shrink. However, the resulting decline in the rate base would curtail profits providing a powerful incentive to prevent this decline from occurring.

The FA study shows that the pipelines' net investment did not decline during this period of declining sales but instead expanded substantially. For example, over the 1977-1984 period, the pipelines accumulated depreciation charges were $7.9 billion, which absent new investment, would have greatly reduced the twenty-five pipelines' 1977 net depreciated investment of $11.3 billion. However, because of new investments during the period (approximately $14.3 billion), the pipelines not only offset the entire $7.9 billion of depreciation, but actually increased their net depreciated investment from $11.3 billion in 1977 to $15.6 billion in 1984. This helps to explain how the net operating earnings over the 1977-1984 period could increase by 67% while sales to end users declined by 7%.

D. Foster Associates Study

Attachment 3 provides a tabulation of the key statistics for the twenty-five pipeline composite. The FA study provides detailed information on each of the twenty-five pipelines and for the pipeline group composite; a detailed description of the methodology used in the study including a map which explains how each number in the study was developed; and a convenient summary of the key assumptions.

Attachment 1

GAS PIPELINE RETURNS ON AVERAGE COMMON EQUITY

Company Name	1977 (%)	1978 (%)	1979 (%)	1980 (%)	1981 (%)	1982 (%)	1983 (%)	1984 (%)
ANR Pipeline Co.	18.54	19.36	15.66	14.26	13.99	13.83	16.59	21.36
Arkla, Inc.	16.13	21.75	17.00	18.53	19.92	22.40	14.33	21.17
Colorado Interstate	15.26	17.08	14.62	19.06	16.94	20.13	17.00	26.31
Columbia Gas Transmission Co.	10.91	14.92	14.89	12.85	12.31	5.00	16.03	8.42
Columbia Gulf Transmission Co.	13.21	12.96	13.43	12.34	11.75	13.77	18.57	17.57
Consolidated Gas Transmission Co.	10.14	8.97	11.03	9.20	13.79	11.47	22.40	16.85
El Paso Natural Gas Co.	23.39	14.41	17.31	12.44	15.95	10.35	18.86	14.21
Florida Gas Transmission Co.	18.57	22.40	20.67	23.26	38.47	58.79	41.45	60.71
Mississippi River Transmission Corp.	29.50	24.97	30.06	23.09	18.87	16.85	12.28	19.30
Montana-Dakota Utilities Co.	- 4.21	- 0.73	- 1.07	- 3.90	- 6.24	2.33	- 1.02	0.42
Natural Gas Pipeline Co. of America	19.96	12.86	19.26	15.14	14.16	16.29	17.72	16.85
Northern Natural Gas Co.	14.96	16.09	10.18	9.02	10.39	12.75	17.23	18.87
Northwest Central Pipeline Corp.	24.67	25.86	18.26	18.54	15.94	19.16	16.33	22.00
Northwest Pipeline Corp.	17.94	11.34	17.00	16.45	14.08	13.02	12.27	11.77
Panhandle Eastern Pipe Line Co.	10.67	9.57	9.28	2.34	5.30	- 1.57	9.19	11.43
Sea Robin Pipeline Co. 1/	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Southern Natural Gas Co.	24.52	22.59	18.37	19.00	15.66	17.60	18.97	19.92
Tennessee Gas Pipeline Co.	10.43	9.08	8.44	11.61	13.62	15.41	16.31	17.18
Texas Eastern Transmission Corp.	17.38	15.19	13.40	13.40	7.34	11.47	17.79	19.38
Texas Gas Transmission Corp.	15.39	13.28	12.42	13.09	14.57	13.56	16.86	18.37
Transco Gas Supply Co. 2/	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Transcontinental Gas Pipe Line Corp.	23.17	19.84	26.18	31.74	13.55	25.07	21.99	19.79
Transwestern Pipeline Co.	14.59	12.59	21.58	17.37	15.60	13.74	12.40	15.10
Trunkline Gas Co.	28.44	19.70	18.17	13.08	14.14	10.81	9.64	19.57
United Gas Pipe Line	28.83	26.93	33.14	36.44	30.92	25.96	15.14	12.66
ARITHMETIC AVERAGE	17.49	16.13	16.49	15.61	14.83	16.01	16.45	18.66
WEIGHTED AVERAGE	17.33	15.48	15.61	15.16	14.12	14.45	15.63	16.89
MEDIAN	17.38	15.19	17.00	14.26	14.16	13.77	16.59	18.37
FERC AUTHORIZED RETURNS ON COMMON EQUITY, MEDIAN 3/	12.75	12.75	13.00	12.94	13.12	13.88	14.88	15.40

1/ Excluded because the very high rates of return calculated for Sea Robin reflect tax liabilities passed on to the owners: Sonat Inc., and United Energy Resources, Inc.

2/ Excluded because company has practically no investment in utility plant, and therefore indicated rates of return are not meaningful.

3/ THE FERC Authorized return entry represents FERC rates of return specified in rate cases settled during the year listed and does not take into account authorized rates of return specified in earlier years and still in effect during a particular year. As a result, during the 1980's this entry overstates the median authorized rate of return in effect, because the authorized rates of return grew over this period. Thus, the actual returns may have exceeded the authorized rates of returns by more than shown in the table.

Attachment 2

GAS PIPELINE RETURNS ON AVERAGE RATE BASE

Company Name	1977 (%)	1978 (%)	1979 (%)	1980 (%)	1981 (%)	1982 (%)	1983 (%)	1984 (%)
ANR Pipeline Co.	13.91	14.37	12.69	12.12	12.28	12.18	13.94	17.40
Arkla, Inc.	12.72	15.07	12.63	14.04	15.77	16.49	11.64	16.14
Colorado Interstate	10.66	11.54	10.80	13.09	13.03	14.25	13.30	19.18
Columbia Gas Transmission Co.	9.22	11.57	11.32	10.64	10.59	7.68	12.24	8.83
Columbia Gulf Transmission Co.	10.26	10.19	10.47	10.31	10.49	11.66	13.73	13.59
Consolidated Gas Transmission Co.	8.60	8.15	9.30	8.89	11.07	10.54	15.29	13.06
El Paso Natural Gas Co.	13.66	10.38	12.23	10.97	13.24	11.43	14.46	13.34
Florida Gas Transmission Co.	13.53	15.79	15.45	17.64	20.40	29.91	25.34	34.56
Mississippi River Transmission Corp.	20.27	18.77	23.27	19.54	17.25	15.68	12.12	18.02
Montana-Dakota Utilities Co.	3.03	4.40	4.40	3.70	2.87	6.07	4.59	5.42
Natural Gas Pipeline Co. of America	12.90	9.90	13.21	11.47	12.18	12.96	14.12	13.77
Northern Natural Gas Co.	11.52	12.50	9.33	9.11	11.10	11.79	14.53	15.84
Northwest Central Pipeline Corp.	20.37	19.93	15.14	15.60	14.13	16.26	14.65	18.29
Northwest Pipeline Corp.	11.58	9.66	12.77	13.29	12.43	13.38	12.98	12.64
Panhandle Eastern Pipe Line Co.	9.44	8.92	9.13	5.64	7.15	4.64	10.33	11.47
Sea Robin Pipeline Co. [1]	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Southern Natural Gas Co.	16.19	16.11	15.33	16.18	13.39	14.37	16.07	16.71
Tennessee Gas Pipeline Co.	9.49	8.71	8.58	10.56	12.23	13.71	14.06	14.77
Texas Eastern Transmission Corp.	12.03	11.51	10.74	11.60	9.04	11.58	14.83	15.87
Texas Gas Transmission Corp.	12.62	11.54	11.16	11.54	12.08	12.90	15.16	16.17
Tranco Gas Supply Co. [2]	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.	N.M.F.
Transcontinental Gas Pipe Line Corp.	11.10	10.46	12.12	14.39	9.64	13.66	14.55	14.05
Transwestern Pipeline Co.	11.46	10.52	17.08	14.76	14.07	12.98	11.43	13.85
Trunkline Gas Co.	17.07	13.81	13.35	12.04	13.32	11.23	10.74	14.02
United Gas Pipe Line	20.13	19.98	23.11	26.73	22.63	20.01	13.90	13.20
ARITHMETIC AVERAGE	12.69	12.34	12.77	12.78	12.63	13.28	13.65	15.23
WEIGHTED AVERAGE	12.42	11.83	12.06	12.18	12.22	12.56	13.83	14.62
MEDIAN	12.03	11.54	12.23	12.04	12.28	12.96	13.94	14.05
FERC AUTHORIZED RATE OF RETURN MEDIAN [3]	9.66	10.12	10.08	10.75	11.16	11.36	12.86	13.36

[1] Excluded because Company reports no income tax liability, and therefore rates of return are non-comparable; income tax liability is passed on to parents; Sonat, Inc. and United Energy Resources, Inc.

[2] Excluded because company has practically no investment in utility plant, and therefore indicated rates of return are not meaningful.

[3] THE FERC Authorized return entry represents FERC rates of return specified in rate cases settled during the year listed and does not take into account authorized rates of return specified in earlier years and still in effect during a particular year. As a result, during the 1980's this entry overstates the median authorized rate of return in effect, because the authorized rates of return grew over this period. Thus, the actual returns may have exceeded the authorized rates of returns by more than shown in the table.

Attachment 3

Summary of Key Statistics on 25 Pipeline Companies From Foster Associates Study on the Financial Performance of Major U.S. Interstate Pipelines

	1977	1978	1979	1980	1981	1982	1983	1984
Return on Total Capital (Rate Base) (%)								
Gas Pipelines (Weighted Average)	12.4	11.8	12.1	12.2	12.2	12.6	13.8	14.6
Value Line 900 Industrials	12.3	12.9	14.8	13.7	12.9	10.3	11.2	12.7
Authorized Rate (Median)	9.7	10.1	10.2	10.8	11.2	11.4	12.9	13.4
Return on Common Equity								
Gas Pipelines (Weighted Average)	17.3	15.5	15.6	15.2	14.1	14.5	15.6	16.9
Value Line 900 Industrials	14.6	15.2	17.9	15.8	14.3	10.5	11.5	13.7
Authorized Rate (Median)	12.8	12.8	13.0	12.9	13.1	13.9	14.9	15.4
Gas Volumes (TCF)								
System Sales	12.8	13.2	14.1	14.1	14.3	13.0	11.2	11.2
Transport for Others	2.6	3.0	3.4	3.6	4.4	4.1	4.0	5.2
Total Deliveries:[2]	15.3	16.1	17.5	17.8	18.7	17.1	15.3	16.4
MEMO: Gas Sales to End Users	8.5	8.8	9.6	9.5	9.5	8.6	7.8	7.9[1]
Net Operating Income								
Total (Billion $)	1.57	1.61	1.73	1.86	2.03	2.31	2.60	2.63
Per MCF of Total Deliveries ($/MCF)	.10	.10	.10	.11	.11	.14	.17	.16
Per MCF of Gas to End Users ($/MCF)	.18	.18	.18	.20	.21	.27	.34	.33[1]
Pipeline Markup Per MCF to End Users ($/MCF)[1]								
Operating and Maintenance Expense	.30	.35	.42	.51	.62	.77	.85	.86
Depreciation	.12	.13	.13	.14	.16	.17	.17	.17
Taxes Other Than Income	.03	.04	.06	.07	.05	.06	.06	.06
Income Taxes	.13	.13	.12	.12	.14	.16	.21	.22
Net Operating Income After Tax	.18	.18	.18	.20	.21	.27	.34	.33
Total[2]	.77	.83	.91	1.04	1.17	1.42	1.62	1.64
Cash Flow Analysis (Billion $)								
Total Cash Flow	2.72	2.76	3.43	3.38	3.97	4.42	4.33	4.64
Additions to Gas Plant	1.09	1.56	1.60	1.99	2.71	2.73	1.35	1.32
Surplus to Gas Plant	1.63	1.20	1.83	1.39	1.26	1.69	2.98	3.32
Cash Flow per MCF to End Users ($/MCF)	.32	.31	.36	.35	.42	.51	.56	.59
Gas Plant Investment (Billion $ at End of Year)								
Gross Investment	22.38	23.85	25.44	27.37	29.80	32.24	33.47	34.58
Accummulated Depreciation	(11.04)	(11.99)	(12.97)	(14.08)	(15.18)	(16.43)	(17.73)	(18.97)
Net Depreciated Investment[3]	11.33	11.86	12.46	13.29	14.61	15.81	15.74	15.61

[1] Arkla, Inc. did not report gas sales to end users in 1984 Form 2 so their 1983 figure was used in 1984 composite data to have a consistent data series for 25 pipelines.

[2] Totals might not equal the sum of the columns due to arithmetic rounding.

[3] Net depreciation might not equal the gross investment minus the accumulated depreciation due to arithmetic rounding.

Senator NICKLES. Mr. Eck, thank you very much.

Our next panelist is Ray Hefner, president of Bonray Energy Corp., and chairman of the Independent Petroleum Association of America.

Mr. Hefner.

STATEMENT OF RAYMOND H. HEFNER, JR., PRESIDENT, BONRAY ENERGY CORP., AND CHAIRMAN, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, OKLAHOMA CITY, OK

Mr. HEFNER. Thank you, Mr. Chairman.

Let me summarize the written statement before you. I am Raymond Hefner, and I appear today in my capacity as chairman of the Independent petroleum Association of America.

Attached to our statement is a copy of our filing with the FERC earlier this week on its current proposed rulemaking covering block billing. Independent producers are opposed to block billing, not because we support the chaotic status quo, but because we believe it would lead to further declines in natural gas reserves as a disincentive to new drilling, and because we believe it is administratively unworkable.

One of the causes of today's problems in the marketing of natural gas is a direct result of more than 25 different wellhead prices for different vintages of natural gas. We can't see how that problem can be overcome by now adding a two-tier price system at the other end of the pipeline, a two-tier system which would be different for each of the more than 100 interstate pipelines, and which would change daily on each pipeline.

Producers were delighted on October 9 when the FERC issued Order 436. It was viewed by them as a new day of true competitive markets that had finally arrived through open transportation. That elation quickly died on November 1 when only eight pipelines opted to be transporters, and most of them may not be so past December 15. Something must be done, and done quickly.

We direct your attention to the chart and table on pages 6 and 7 of our written testimony. In terms of constant dollars, dollars which have been adjusted for inflation, consumers have seen the spread between the wellhead and the burner tip widen each year. In constant terms, wellhead prices rose by $2.14 per mcf between 1973 and 1984, but the price paid by residential consumers increased by $3.42. Remember, those are inflationless figures.

The increase in wellhead prices are a reflection of a change from ridiculously low wellhead prices in 1973 to a new era of generally higher energy prices in 1984. But what about the spread? What, except for inflation which has already been accounted for in these numbers, could account for the other $1.28? Especially considering that we are dealing with relatively mature transportation and distribution systems?

The answer appears that the FERC and the local PUC's have been granting ever greater returns to pipelines and distributors without apparent justification. Because of this past record of counterproductive regulations, we don't believe the FERC has the authority or the will to solve the many problems facing us.

Therefore, we recommend that the Congress move quickly to adopt legislation which will accomplish the following:

One, mandate meaningful transportation requirements on interstate pipelines, intrastate pipelines, and local distribution companies.

Two, end price controls at the wellhead on all natural gas allowing only contract terms to dictate price and related conditions.

Three, repeal the Fuel Use Act in incremental pricing.

And four, provide a mechanism whereby producers can form cooperative market entities to more effectively market their gas.

Mr. Chairman, we commend you for having introduced S. 1302 which deals with the wellhead pricing and use-constraint aspects of our recommendation. We also commend Senator Bradley for his interest in transporation and his introduction of S. 834. We would be most pleased to have the opportunity, in light of developments since that legislation was introduced, to expand and blend the scope of those proposals into a single legislative thrust.

In addition, Mr. Chairman, since we prepared our statement for this hearing, the Department of Energy has used its unique authority to initiate a FERC rulemaking relating to old gas pricing. Without having had a chance to study it in detail, we aren't in a position to address its merits or its shortcomings today.

However, we do commend DOE for giving the FERC this alternative to its flawed block billing concept, and hope the FERC will move quickly to receive comments and give consideration to the DOE proposal. Thank you.

[The prepared statement [1] of Mr. Hefner and a statement from the International Association of Drilling Contracts follow:]

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[1] The International Association of Drilling Contractors, by letter dated November 21, 1985, requested that their name be stricken from the cover page of the Independent Petroleum Association of America's testimony. See International Association of Drilling Contractors' letter and statement which follows the Independent Petroleum Association of America's statement.

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

AND

AMERICAN ASSOCIATION OF PETROLEUM LANDMEN
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WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION

By

Raymond H. Hefner, Jr.

Before the

Subcommittee on Energy Regulations and Conservation
Committee on Energy and Natural Resources

United State Senate

November 21, 1985

I am Raymond H. Hefner, Jr., an independent oil and gas producer from Oklahoma City. I am appearing here today as Chairman of the Independent Petroleum Associaton of America. Together with the more than 35 unaffiliated state and regional associations which join us in the these comments, I am speaking on behalf of nearly all of the more than 12,000 independent oil and natural gas producers operating in all of the domestic oil and gas provinces of the U.S., particularly onshore in the lower 48 states.

We are pleased today to have an opportunity to address the distressed state of affairs in the natural gas industry, particularly as they relate to recent and proposed FERC actions.

Comments we filed with the FERC earlier this week have been attached to this statement and we hope that they will be reflected in the hearing record as our most recent view of block pricing.

I would like to highlight the essence of those comments. We commend the FERC for finally recognizing that the multitude of prices resulting from more than 40 years of wellhead price controls are creating havoc in our attempt to price natural gas in the marketplace in a rational manner. However, having said that, we take strong objection to the Commission's proposed solution -- namely two tier pricing of gas. If it has not been bad enough to have more than 25 different pricing levels at the wellhead over recent years, now FERC is proposing two different prices per pipeline at the citygate and for each pipeline those prices would be different.

Because of this, we don't believe the Commission has the wherewithall to monitor block billing. With more than 100 interstate pipelines involved and with both blocks changing daily as supplies in one block deplete and new supplies are added to the second block, we can't imagine the audit force needed to assure that the intent of the program would be carried out.

And that says nothing as to what final consumers could expect at the burnertip after state public utility commissions got done tinkering with the two prices they addressed at the citygate.

Besides this, producers can see no rationale in the FERC's arbitrary allocation of vintages between blocks. Why does it include only low priced, forever regulated gas in block one? Why does it determine that NGPA incentives to sustain stripper well production should be ended and that stripper wells be put at a distinct disadvantage? These questions, along with many others must be answered by the Commission and we believe if it does address them objectively, it will have to reject its own proposed rule.

Now let us turn to Order 436.

When the Commission first proposed RM 85-1, independent producers were hopeful that they would finally be afforded a new opportunity to market their natural gas. While block pricing and some other questionable features were orginally included in that rulemaking, many producers -- particularly in those frontier areas served by only one or two pipelines -- felt that the transportation features were of such importance that they might even be willing to accept some of the bad to get the good.

Needless to say, they were delighted when Order 436 was issued on October 9. Not only did it give producers apparent open access to new markets, the Commission had set aside two of the more controversial features of the rulemaking dealing with take-or-pay and block billing.

But as has happened too often in the natural gas business, their hopes of a "new day" withered and died on November 1 as pipeline after pipeline refused to offer transportation. Only a handful came forth and rumor is that most, if not all will cease to be transporters after December 15.

Independent producers are frustrated. They are angry. Mr. Chairman, our own Oklahoma independents have called upon Attorney General Meese to investigate the pipeline industry in light of possible anti-trust violations. Those are serious charges, but they are also a reflection of the frustration level of independents.

Having gone as far as it has gone and still come up empty handed, we are not sure that the FERC can do anything to resolve this mess, and if they now proceed with block billing, it only will get worse. Therefore, while we will continue to try to work with the Commission to improve matters, independents again are turning their attention to the Congress in the belief that only with legislation can we resolve the impasse we have reached in the gas industry.

One might say, "so what's new about that? Haven't producers advocated legislation for the past 40 years?"

Our answer is that the idea of legislation is not new, but the circumstances under which we are operating are different.

In the past, when one has suggested full decontrol of natural gas, the immediate reaction of consumer groups was that consumers would be gouged. But that arguement is no longer valid, if in fact it ever was. Our experience with crude oil in 1981 showed that decontrol was good for consumers as a ten-year rise in product prices was halted and reversed.

In spite of that, consumer advocates argued that natural gas was "different" and not only was Congress twarted in 1983 from finishing the job of decontrol, the House of Representatives came close to recontrol of NGPA-era gas out of predictions of a $10 to $12 billion windfall to producers as a result of an alleged fly up. Fortunately for them, they did not succeed. With only partial decontrol consumers are seeing average burnertip prices decline. Full decontrol now would add to price stability for natural gas and we believe Congress should seriously revisit this matter immediately.

We know that there are those who will question the advisability of such action in an election year, but we feel that the gas industry and ultimately consumers cannot wait. The election year question evolves from the assumption that natural gas legislation is too "political". We say it is time to quit playing politics and look at some hard economic facts that must be addressed.

The following chart and accompanying table point to one of the important economic aspects which must be addressed.

The chart shows in constant and current dollars what has been happening between the wellhead and the burnertip in interstate markets since 1973 -- before the old FPC initiated its new increases in area rates.

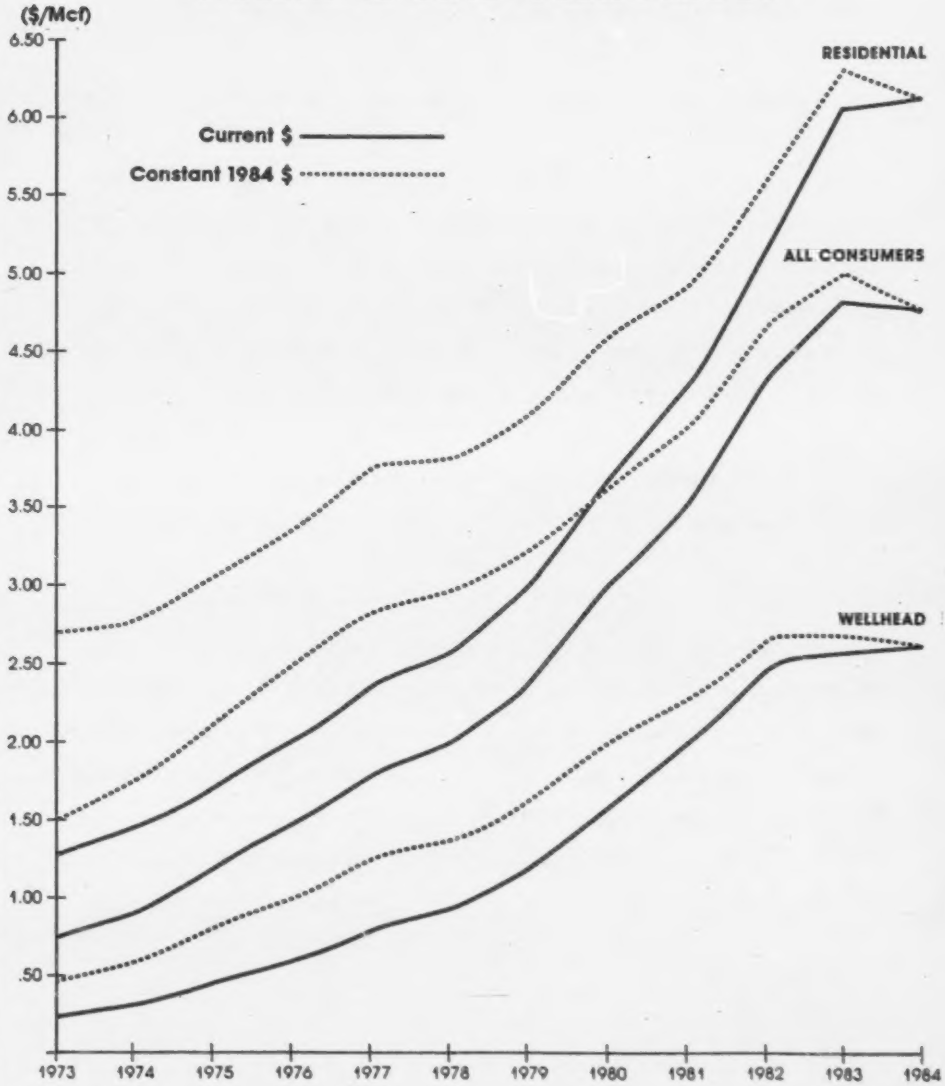
In terms of constant dollars -- dollars which have been adjusted for inflation -- consumers have seen the spread between the wellhead and the burnertip widen each year.

In constant terms, wellhead prices rose by $2.14 per Mcf between 1973 and 1984, but the price paid by residential consumers increased by $3.42. Remember, those are "inflationless" figures. The increase in wellhead prices are a reflection of a change from ridiculously low wellhead prices in 1973 to a new era of generally higher energy prices in 1984. But what about the spread? What, except for inflation which has already been eliminated in these numbers, could account for the other $1.28 -- especially considering that we are dealing with relatively mature transportation and distribution systems?

The answer appears to be that the FERC and the local PUC's have been granting ever greater returns to pipelines and distributors without apparent justification.

Only through a system of open transportation -- from every wellhead to every burnertip -- can competition work to prevent such price distortions. We don't believe the FERC has the authority or ability to artificially induce such competition and therefore believe that only through legislation can consumers be assured that they not only will get the most economically priced supplies from the wellhead, but that those supplies will be delivered to them in a most efficient manner.

COMPARISON OF U.S. NATURAL GAS WELLHEAD AND USER PRICES



Source: Energy Information Administration

IPAA Chart

COMPARISON OF U.S. NATURAL GAS
WELLHEAD AND USER PRICES

($/Mcf)	WELLHEAD		RESIDENTIAL		ALL CONSUMERS	
	Current $	Constant 1984 $	Current $	Constant 1984 $	Current $	Constant 1984 $
1973	0.22	0.46	1.29	2.70	0.73	1.50
1974	0.30	0.58	1.43	2.77	0.89	1.73
1975	0.45	0.80	1.71	3.04	1.19	2.11
1976	0.58	0.98	1.98	3.34	1.47	2.48
1977	0.79	1.26	2.35	3.75	1.78	2.84
1978	0.91	1.35	2.56	3.80	1.98	2.94
1979	1.18	1.61	2.98	4.07	2.34	3.20
1980	1.59	1.99	3.68	4.60	2.91	3.64
1981	1.98	2.26	4.29	4.90	3.51	4.01
1982	2.46	2.65	5.17	5.57	4.32	4.65
1983	2.59	2.69	6.06	6.29	4.82	5.00
1984	2.60	2.60	6.12	6.12	4.78e	4.78e

Source: Energy Information Administration,
Natural Gas Monthly

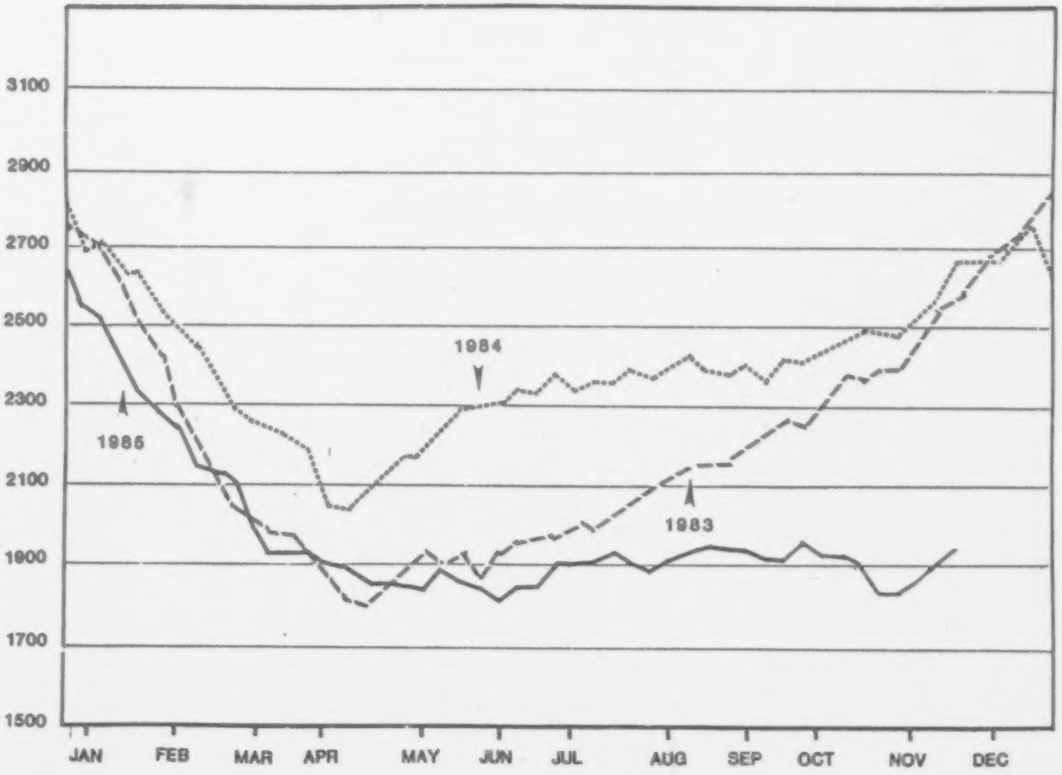
e = IPAA Estimate

Another area of concern to everyone, whether they realize it or not, is the threat of future natural gas shortages.

The following chart shows what has happened to new oil and natural gas drilling in recent months -- an early indicator of the availability of future gas supplies.

While it is impossible to say with certainty what has caused the continuing drilling slump, chaos in natural gas markets along with this year's threat of adverse tax actions by Congress must be considered as the major contributing factors. Considering the fact that we have not had net additions to gas reserves since 1981 when we hit a peak of 4,600 active operating rigs, the 1985 drilling rate certainly indicates a further deterioration in the reserve - to - production ratio -- and at some point in the not too distant future consumers again can expect shortages unless we reverse this drilling trend. Congressional action to adopt comprehensive natural gas legislation along with an early end to the deteriorating tax reform process in Congress are the only two actions which could possibly be expected to get our industry going again.

ROTARY RIGS ACTIVE



IPAA CHART

Therefore we recommend that the Congress move quickly to adopt legislation which will:

1). Mandate meaningful transportation requirements on interstate pipelines, intrastate pipelines and local distribution companies;

2). End price controls at the wellhead on all natural gas allowing only contract terms to dictate price and related conditions;

3). Repeal the Fuel Use Act and incremental pricing, and;

4). Provide a mechanism whereby producers can form cooperative market entities to more effectively market their gas.

Mr. Chairman, we commend you for having introduced S. 1302 which deals with the wellhead pricing and use constraint aspects of our recommendation. We also commend Senator Bradley for his interest in transportation and his introduction of S. 834. We would be most pleased to have the opportunity, in light of developments since that legislation was introduced, to expand and blend the scope of those proposals into a single legislative thrust.

More than 40 years of treating natural gas differently then any other commodity has failed. It's time we took from the regulators and gave to the free market the task of allocating resources and elliciting needed future supplies within the natural gas industry.

Thank you.

STATEMENT OF

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

AND

AMERICAN ASSOCIATION OF PETROLEUM LANDMEN
ARKANSAS ROYALTY MEMBERSHIP
CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION
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VIRGINIA OIL AND GAS ASSOCIATION
WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION

FEDERAL ENERGY REGULATORY COMMISSION

RE: RM 85-1-000
(Part D)

November 18, 1985

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas) Pipeline after Partial Decontrol)	)))	Docket No. RM85-1-000 (Part D)

SUPPLEMENTAL COMMENTS OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

The Independent Petroleum of America and other state and regional oil and gas associations listed on the cover sheet offer these comments in response to the Notice of Proposed Rulemaking isssued on May 30, 1985 by the Federal Regulatory Commission. IPAA and the other listed associations represents the more than 12,000 independent explorer-producers of domestic crude oil and natural gas.

In that independents drill 89 percent of all wildcat wells, 86 percent of all wells and find 60 percent of all domestic natural gas reserves, they have a vital interest in a healthy, expanding natural gas producing, transportation and marketing industry. With that in mind, it is obvious that independents have valid reasons to be concerned about any legislative or regulatory actions confronting the natural gas industry.

All correspondence and comments regarding this matter should be addressed to:

Lloyd N. Unsell, Executive Vice President
Independent Petroleum Association of America
1101 16th Street, N.W.
Washington, D.C. 20036

Introduction

Nothing has really changed since our filing in July to alter our opposition to block pricing of natural gas.

In fact, in light of the nature of the Commission's new proposed rulemaking, our opposition has intensified.

In our previous filing we urged the Commission to abandon block billing and instead initiate a new "just and reasonable" proceeding for all categories of old natural gas.

Recognizing that the Commission apparently had already reviewed those options, we tried to suggest some changes within the block pricing concept which would ease producer concerns.

Included in those suggestions were the inclusion of all pre-1985 gas in block one, or; the inclusion of all forever regulated gas in block one, or; at a minimium the inclusion of Section 107 and 108 in block one by virtue of their clear designation as incentive categories under both wellhead and incremental pricing provisions of NGPA.

Since the Commission, by its actions in this proposed rulemaking, apparently have ignored those attempts on our part to compromise block pricing, we see no other course than to oppose the entire concept contained therein.

Restating the Problem

We commend the FERC for finally recognizing that the multitude of prices resulting from more than 40 years of wellhead price controls are creating havoc in our attempt to price natural gas in the marketplace in a rational manner. However, having said that, we voice strong objection to the Commission's proposed solution -- namely two tier pricing of gas. If it has not been bad enough to have more than 25 different pricing levels at the wellhead over recent years, now FERC is proposing two different prices at the citygate for each pipeline, and for each pipeline those prices would be different.

Because of this, we don't believe the Commission has the wherewithall to monitor block billing. With more than 100 interstate pipelines involved and with both blocks changing daily as supplies in one block deplete and new supplies are added to the second block, we can't imagine the audit force needed to assure that the intent of the program would be carried out.

And that says nothing as to what final consumers could expect at the burnertip after state public utility commissions got done tinkering with the two prices they addressed at the citygate.

Besides this, producers can see no rationale in the FERC's arbitrary allocation of vintages between blocks. Why does it include only low priced, forever regulated gas in block one? Why does it determine that NGPA incentives to sustain stripper well production should be ended and that stripper wells be put at a distinct disadvantage? These questions, along with many others must be answered by the Commission and we believe if it does address them objectively, it will have to reject its own proposed rule.

Wellhead Pricing Not Chief Culprit

In its proposed rulemaking, the Commission has placed entirely too much emphasis on wellhead prices, and not enough on what has happened after natural gas leaves the wellhead.

We are convinced that one of the chief causes for the inability of consumers of natural gas to send clear market signals to producers has been the ever increasing margins which have been extracted by pipelines and distributions.

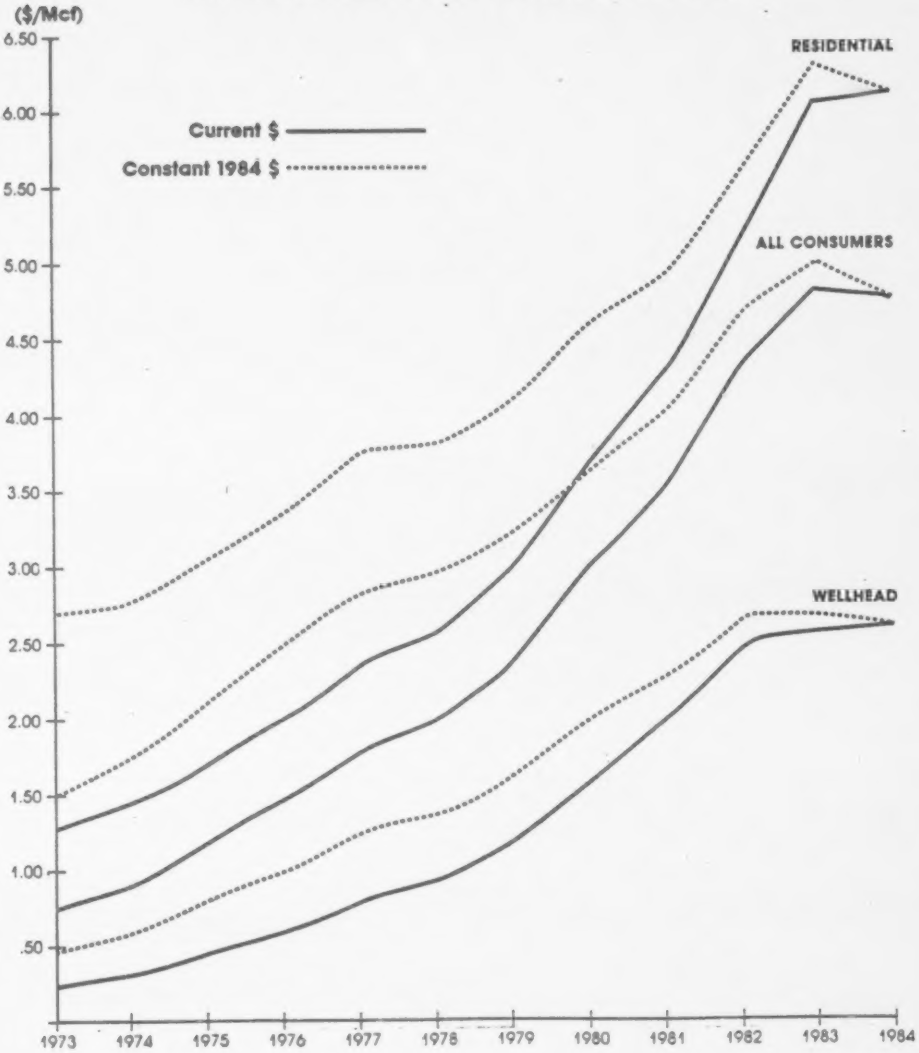
The following chart and accompanying table vividly makes the point.

The chart shows in constant and current dollars what has been happening between the wellhead and the burnertip in interstate markets since 1973 -- before the old FPC initiated its new increases in area rates.

In terms of constant dollars -- dollars which have been adjusted for inflation -- consumers have seen the spread between the wellhead and the burnertip widen each year.

In constant terms, wellhead prices rose by $2.14 per Mcf between 1973 and 1984, but the price paid by residential consumers increased by $3.42. Remember, those are "inflationless" figures. The increase in wellhead prices are a reflection of a change from ridiculously low wellhead prices in 1973 to a new era of generally higher energy prices in 1984. But what about the spread?

COMPARISON OF U.S. NATURAL GAS WELLHEAD AND USER PRICES



Source: Energy Information Administration

IPAA Chart

COMPARISON OF U.S. NATURAL GAS
WELLHEAD AND USER PRICES

($/Mcf)	WELLHEAD		RESIDENTIAL		ALL CONSUMERS	
	Current $	Constant 1984 $	Current $	Constant 1984 $	Current $	Constant 1984 $
1973	0.22	0.46	1.29	2.70	0.73	1.50
1974	0.30	0.58	1.43	2.77	0.89	1.73
1975	0.45	0.80	1.71	3.04	1.19	2.11
1976	0.58	0.98	1.98	3.34	1.47	2.48
1977	0.79	1.26	2.35	3.75	1.78	2.84
1978	0.91	1.35	2.56	3.80	1.98	2.94
1979	1.18	1.61	2.98	4.07	2.34	3.20
1980	1.59	1.99	3.68	4.60	2.91	3.64
1981	1.98	2.26	4.29	4.90	3.51	4.01
1982	2.46	2.65	5.17	5.57	4.32	4.65
1983	2.59	2.69	6.06	6.29	4.82	5.00
1984	2.60	2.60	6.12	6.12	4.78e	4.78e

Source: Energy Information Administration, Natural Gas Monthly

e = IPAA Estimate

What, except for inflation which has already been accounted for in these numbers, could account for the other $1.28 -- especially considering that we are dealing with relatively mature transportation and distribution systems?

The answer appears that the FERC and the local PUC's have been granting ever greater returns to pipelines and distributors without apparent justification.

Only through a system of open transportation -- from every wellhead to every burnertip -- can competition work to prevent such price distortions. We don't believe the FERC has the authority or ability to artificially induce such competition and therefore believe that only through legislation can consumers be assured that they not only will get the most economically priced supplies from the wellhead, but that those supplies will be delivered to them in a most efficient manner.

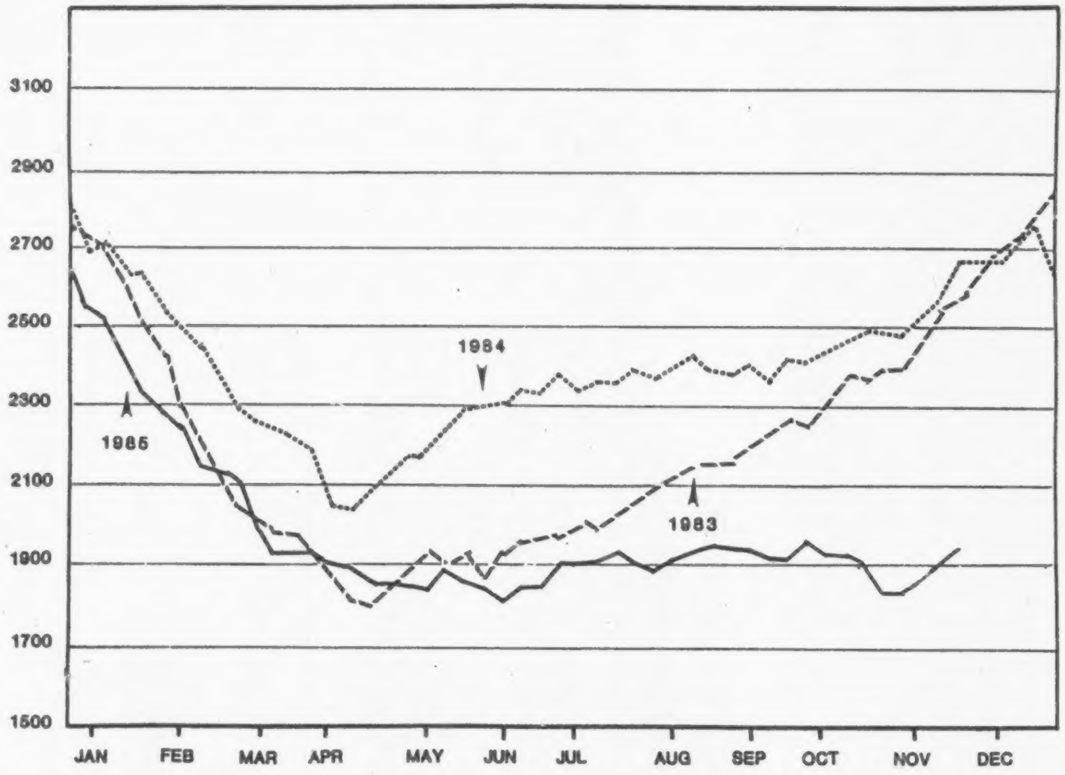
Add to that the need for total and final wellhead price control to "level the price playing field", and we find ourselves questioning whether the Commission has either the authority or the will to meet the industry's needs.

Plunging Drilling, Reserves Additions

In another area of concern to everyone, whether they realize it or not, is the threat of future natural gas shortages. The following chart shows what has happened to new oil and natural gas drilling in recent months -- an early indicator of the availability of future gas supplies.

While it is impossible to say with certainty what has caused the continuing drilling slump, chaos in natural gas markets along with this year's threat of adverse tax actions by Congress must be considered as the major contributing factors. Considering the fact that we have not had net additions to gas reserves since 1981 when we hit a peak of 4,600 active operating rigs, the 1985 drilling rate certainly indicates a further deterioration in the reserve - to - production ratio -- and at some point in the not too distant future consumers again can expect shortages unless we reverse this drilling trend.
Congressional action to adopt comprehensive natural gas legislation along with an early end to the deteriorating tax reform process in Congress are the only two actions which could possibly be expected to get our industry going again.

ROTARY RIGS ACTIVE



IPAA CHART

Conclusion

In light of the magnitude of industry problems, we would urge the Commission to set aside this proposed rulemaking immediately and join us in calling upon the Congress to initiate immediate legislative action to:

1). Mandate meaningful transportation requirements on interstate pipelines, intrastate pipelines and local distribution companies;

2). End price controls at the wellhead on all natural gas allowing only contract terms to dictate price and related conditions;

3). Repeal the Fuel Use Act and incremental pricing, and;

4). Provide a mechanism whereby producers can form cooperative market entities to more effectively market their gas.

Instead of spending further time and effort of the Commission and the industry arguing over block pricing, we believe the Commission should return its full attention to transportation problem and initiate actions which will get gas moving again. Obviously, transportation under Order 436 is not working and the Commission must give that its full attention.

INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

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Suite 702
Washington, D.C. 20036
Tel: 202-293-0670

Brian T. Petty
Manager of Government Affairs

November 21, 1985

The Honorable Don Nickles
Chairman, Subcommittee on
Energy, Regulation and Conservation
Committee on Energy and Natural Resources
United States Senate
306 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Senator Nickles:

Attached are comments offered by the International Association of Drilling Contractors (IADC) to the Federal Energy Regulatory Commission (FERC) on FERC's proposed rulemaking RM85-1-000. IADC respectfully requests that this item be included in the record of hearings conducted on November 21, 1985 before your subcommittee on review of FERC order # 436. IADC offered testimony on the same subject before your subcommittee on September 19, 1985, and we want to reiterate our very serious concern about the "block billing" provisions of the FERC proposed rulemaking.

IADC also wants to make clear that this submission of written testimony is the only position for the record of the IADC. Unfortunately, the Independent Petroleum Association of America (IPAA) included IADC's name as offering support for the IPAA testimony this date by Mr. Ray Hefner, President of IPAA. Inclusion of IADC's name was inadvertent, and without IADC's permission. Thus, while we support much of the IPAA position reflected in Mr. Hefner's testimony, we feel that both producer and pipeline industry segments have suffered from years of misguided federal regulation, and particularly from the failure of the Congress to deregulate all categories of natural gas.

IADC sincerely appreciates the opportunity to make its position known to you and the subcommittee. This represents our position fully; I am available to you if you need further amplification of that position.

Sincerely,

Brian T. Petty

Brian T. Petty

IADC Headquarters P.O. Box 4287, Houston, Texas 77210 Tel: 713-578-7171

STATEMENT
ON
FERC PROPOSED RULEMAKING (RM85-1-000)
AND
FERC ORDER #436
# of the
INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

INTERNATIONAL
ASSOCIATION OF
DRILLING CONTRACTORS

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FEDERAL ENERGY
REGULATORY COMMISSION

COMMENTS OF
INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS
ON RM85-1

The International Association of Drilling Contractors (IADC) is a trade association composed of over 1500 member companies engaged in all aspects of oil and gas drilling, exploration and production.

A large majority of IADC's members are onshore drilling contractors. As such, they have provided the hardware to find and develop our nation's oil and gas energy resources. As is generally known, the oil and gas industry is enduring significant hard times. This is best illustrated by the precipitous decline in the rotary rig count. In 1981 the rig count averaged 3,973, and since then, there has been a reduction of almost 50% in the number of rigs working throughout the United States. This represents a steady, dangerous decline from 1981. In 1982, that number stood at 3,116; in 1983, at 2,226; in 1984, at 2,428; and currently, is below 2,000.

An equally unsettling trend has occurred in the total number of available rigs. From a high of 4,803 in 1981, only a few more than 4,000 rigs are available today, and that number is dropping fast. With the number of available rigs shrinking comes the ever-greater risk that when an upturn in demand for drilling services begins, there may well be a shortage of rigs, with a consequent pinch in the development of new oil and gas reserves. The loss of rigs over these five years has been due to various factors tied to the financial health of the contract drilling

PRESIDENT: THOMAS E. HOGAN
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SOUTHEAST COAST: Vernon R. Romeo

OFFSHORE: John R. Huff
ROCKY MOUNTAIN: David L. True

PACIFIC COAST: J. E. Settle
WEST TEXAS-EAST NEW MEXICO: Ray Brazzel
NORTHEAST TEXAS-NORTH LOUISIANA-
SOUTH ARKANSAS: C. A. Hensen

industry. Many companies have gone bankrupt and many rigs are simply rusting in stacks, or are being "cannibalized" as cash-short contractors borrow pieces of existing rigs when they formerly bought new parts. Another indicator of the weakness of the industry is the total number of IADC's membership: just three years ago the membership stood at over 2000 member companies and is today 25% off that mark. And, IADC represents virtually the entire contract drilling industry.

The rulemaking proposed by FERC — in particular, "Part D" — will by the most conservative estimates reduce drilling by 30%. Oil companies already in a cash flow bind have drastically reduced their exploration budgets, and FERC now proposes to skew the natural gas market further by enabling certain favored utilities and large industrial consumers to raid low cost gas supplies. This attempt to adjust overnight the results of decades of bad federal regulation will have a serious adverse impact on the contract drilling business, as higher cost "deregulated" gas is shut in for lack of a market. The Natural Gas Policy Act of 1978 (NGPA) invited the development of high cost gas reserves, and the contract drilling industry rose to the challenge with the construction of very large and very expensive deep-drilling rigs. The pipelines' problems with high cost take-or-pay contracts and the sudden drop in oil prices have already made deep gas drilling uneconomic. The FERC proposed rulemaking would deliver the rabbit punch to producers struggling to manage their "new" gas reserves which the federal government induced them to seek.

FERC proposes to accomplish what Congress has not permitted. Since Congress has not yet taken the step to deregulate "old" natural gas, the market is even now trying to sort itself out. This would be greatly aided, of course, if natural gas could seek market levels just as oil and coal do. IADC remains strongly in favor of total deregulation of all natural gas categories. Through this proposed rulemaking, FERC attempts to tilt the natural gas market at all costs in favor of the local distribution companies, which are impatient with the facts of the marketplace. The much-talked about "level playing field" sought by FERC is an attempt to give the LDC's free run of that field while forcing producers and pipelines to the benches, and drilling contractors to the showers.

The contract drilling industry simply cannot survive a 30% or more drop in drilling activity. The FERC rulemaking, if adopted , would accelerate the number of bankruptcies in the industry, the decline in the available rig rate, and dependence on foreign sources of oil and gas. The Congress and FERC (and its predecessor, the FPC) have through years of keeping natural gas at artificially low price levels created the uneven playing field we find ourselves on. The industry is gradually working the market out, but this will not be done without a sharing of the pain necessary to untangle years of misguided legislative and regulatory policies for natural gas. The contract drilling industry has taken quite a bit of the pain up to now; producers who cannot market "new" gas under NGPA are suffering as well. FERC's attempt to insulate the LDC's from pain is an end run effort on the playing field.

Respectfully submitted,

Brian T. Petty

Brian T. Petty
Manager of Government Affairs
International Association of
Drilling Contractors
1901 L Street, N.W., Suite 702
Washington, D.C. 20036

Date: November 18, 1985

Senator NICKLES. Mr. Hefner, thank you very much for your comments.

Our next panelist is John Watson, vice president for government affairs for Mitchell Energy, and also representing the Texas Independent Producers & Royalty Owners Association. Mr. Watson.

STATEMENT OF JOHN E. WATSON, SENIOR VICE PRESIDENT FOR GOVERNMENT AFFAIRS, MITCHELL ENERGY, CORP., REPRESENTING THE TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, HOUSTON, TX

Mr. WATSON. Thank you, Mr. Chairman, members of the committee: My name is John E. Watson with Mitchell Energy Corporation of the Woodlands, TX, today representing the Texas Independent Producers & Royalty Owners Association, better known as TIPRO.

TIPRO is made up of approximately 5,400 producers and royalty owners, most of whom have interests in or are directly involved with exploration and production of gas here in the United States. We're very, very concerned about this recent Federal Energy Regulatory Commission proposal with respect to block billing that was issued by the Commission as part D of their document RM85-1.

Since we are so concerned about it, we're going to limit our comments today to the block billing proposal. Unfortunately, FERC's proposal is designed to force an artificial drop in gas prices which, in our opinion, will lead to shortages in the future.

FERC has made this proposal, in our view, without regard to our Nation's energy security, without regard to the impact that it will have on competition by purchasers, and without regard to the congressional intent when you all passed the Natural Gas Policy Act of 1978, better known as the NGPA. Under the NGPA, you established a system of incentive pricing which conclusively presumed the existence of rolled-in pricing, a proven and a court-sanctioned policy.

If you'll recall, under rolled-in pricing you merely take the average of the old gas and average it in, or roll it in with the incentive price, or the deregulated price, the higher cost gas, and you end up with an average. It helps eliminate the price distortions.

Under the NGPA, producers were granted an incentive by the Congress to go out and drill for new wells and to find hard-to-produce gas, so-called tight-reservoir gas, as well as to continue producing some of their marginal wells, or stripper gas wells.

Producers, especially the small independent producer, relied on these congressional incentives and have devoted much of their time, and talent, and capital to drilling and exploring for these hard-to-produce reserves. Now FERC proposes to greatly modify this proven system of averaging in the old gas with the higher priced gas, and have come up in favor of an unproven and an untested concept which they refer to as block billing.

FERC under this proposal would segregate the old, low-priced gas and call it block 1, and lump all of the incentive, deregulated, and higher priced gas into what they call block 2. They would then create an enormous subsidy for certain historic purchasers of the interstate pipelines by granting and guaranteeing them the right to all the block 1 gas, merely because they happened to buy gas during an historic period from 1978 through 1984.

We feel that this is very discriminatory and unlawful. The regulatory subsidy that they're granting from the interstate pipelines to their purchasers will go to many large utility monopolies outside the jurisdiction of FERC, and therefore there is no guarantee that the benefits or the reduction in prices that will occur will ever reach the consuming public. This is because the subsidy is being created by transferring the block 1 gas entitlement from the interstate pipelines, as I say, to their historic purchasers.

As a matter of fact, to illustrate this, the gas prices have, as someone has already mentioned, have been reduced considerably over the past year, and yet the homeowners prices have either remained about the same, or have in effect gone up in many instances. That doesn't make a whole lot of sense.

The price reduction that's caused by block billing will result in wellhead revenue losses to producers of, it's been estimated to be anywhere from $3.3 billion to $5 billion. Based on past experience, the independent producers know pretty well who's going to shoulder most of those burdens.

The independents drill about 88 percent of our Nation's exploratory wells, and in 1983 approximately 62 percent of the wellhead sales of natural gas were made by companies other than the 16 largest producers. As a group, the independents have invested in exploration and production for most of the high-cost block 2 incentively priced block 2 gas that FERC has lumped together and would be most subject to these anticompetitive downward pricing pressures if this block billing were adopted.

Independents will be forced to cut back their exploration and production because of these artificially reduced prices. Because the block billing will cause the incentively priced gas contracts to be negotiated downward, we know that the independents are going to suffer more than the larger companies because they just don't have the existing portfolios of gas or the large cash flows or the large legal departments.

We believe that the block billing as proposed by FERC will lead to less wells, less gas, and as I have said before, inevitable shortages. We would urge you here in the Congress to encourage the FERC to abandon the block billing approach and to get on with what most of the panelists have recommended. That is, to decide some J&R rates for these older gas reserves.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Watson follows:]

COMMENTS OF
THE TEXAS INDEPENDENT PRODUCERS
AND ROYALTY OWNERS ASSOCIATION

My name is John E. Watson. I am a Senior Vice President of Mitchell Energy Corporation, The Woodlands, Texas, however, today I am appearing on the behalf of the Texas Independent Producers and Royalty Owners Association, better known as "TIPRO". TIPRO is composed of some 5,400 independent producers and royalty owners, most of whom have interests in or are directly involved with the exploration and production of domestic natural gas.

TIPRO is extremely concerned about the recent Federal Energy Regulatory Commission (FERC) proposal regarding "Block Billing" issued as Part D of Docket Number RM85-1-000. Unfortunately, the rules proposed by FERC are designed to force an artificial drop (some say a "free fall") in gas prices, which, in our opinion, will lead to future gas shortages without regard to our nation's energy security, without regard to the impact on competition, and without regard to Congressional intent in passing the Natural Gas Policy Act of 1978 (NGPA).

The NGPA established a system of "incentive" pricing which conclusively presumes the existence of "rolled in" pricing, a proven and court sanctioned policy. Under "rolled in" pricing, the controlled price of old flowing gas is averaged with the price of certain new and more costly gas supplies thereby eliminating price distortions in arriving at an average price of gas. Under NGPA, producers were granted an incentive by the Congress to go out and drill new wells, including hard to produce "tight formation" gas as well as to continue production from old marginal wells, or "stripper gas". Producers, especially the smaller independent producers, relied on these Congressional incentives and have devoted much of their time, talent, and capital to exploring for and producing these hard to produce natural gas reserves.

The FERC now proposes to greatly modify this proven system of averaging or "rolled in" pricing in favor of an unproven and untested concept referred to as Block Billing. The FERC would segregate the least expensive old gas categories into one block while all other higher cost gas would be placed in a second block. Thus, FERC proposes to average separately two respective large blocks of gas: one which rolls in the price of the cheapest, old gas; the other, the incentively priced and new gas. The FERC would then create an enormous subsidy to certain classes of historical gas purchasers by guaranteeing to them supplies of natural gas priced significantly below free market levels. This regulatory subsidy benefits many large utility monopolies that are outside FERC jurisdiction, consequently, there will be no guarantee that these benefits will inure to the consuming public. This is because the subsidy is being created by transferring Block 1 gas entitlements from the interstate pipelines to their historic purchasers without any safeguards to insure lower prices to consumers.

The FERC is correct in assuming that the isolation of older flowing gas into Block 1 will artificially force Block 2 incentively priced gas to fall. Unfortunately, there has been no examination or consideration of which categories of Block 2 gas will fall. Historic pipeline customers would own rights to the cheapest Block 1 gas and would doubtlessly maximize their purchases of such gas. This places artificially created pressures on the pipelines to reduce their average purchase price of heretofore incentively priced Block 2 gas. The average price of Block 2 gas can only fall if the price for new and renegotiated purchases of Block 2 gas are below market-clearing levels. This price reduction will result in wellhead revenue losses estimated at $3.3 to $5 billion. Based on experience, independent producers know too well who will shoulder most of these losses.

In 1983, approximately 62% of the wellhead sales of natural gas were made by companies other than the 16 major producers. Independent producers drill about 88% of our nation's exploratory wells. As a group, independent producers have invested in the exploration for and production of most of the more costly, incentively priced "Block 2" gas which would be most subject to these anti-competitive downward pricing pressures. Independents will be forced to cut back exploration and production in the wake of these artificially reduced prices.

On one hand there are large, well financed major producers who enjoy large existing portfolios of gas, have enormous cash flows, large and aggressive legal departments, as well as tightly written contracts that gas purchasers cannot and have not been able to abrogate. On the other hand, there are small independent producers who have historically plowed back most of their production revenues into new production and who are dependent upon a predictable cash flow to compensate for the lack of secure, locked-in financing. They are unaccustomed to litigation but well accustomed to contract abrogations in the form of "market-out" letters. The inevitable bankruptcies, liquidations, and acquisitions that will result from Block Billing will further distort the competitive environment within the domestic natural gas industry.

Based upon the foregoing, I believe that Block Billing as proposed by the FERC will lead to less wells, less gas, and inevitable gas shortages. Indeed, Congress sought to eliminate gas shortages by adopting the NGPA incentive price mechanism. Had Congress intended otherwise, it would have done so as it did in Title 2 of the NGPA which provides for incremental pricing.

-4-

In the long run, Block Billing helps no one. By subsidizing local monopolies with old, below market priced Block 1 gas, new anti-competitive distortions will arise. Initially, the price of new deregulated supplies of gas that are already market sensitive will be averaged with incentive gas, drilled in reliance on the NGPA and priced above market-clearing levels. In the short term, Block Billing will guarantee that the price for new gas and incentive gas will be artificially suppressed below market-clearing levels to overcompensate for FERC's grant of the Block 1 subsidy to entities outside of FERC's control. In the long term, as old, Block 1 gas depletes, the price of available Block 2 supplies will be bid up beyond current prices because the incentive to explore for and produce new supplies would have vanished and independent producers will have significantly disappeared. The additional uncertainty of litigation about the ultimate validity or invalidity of these new FERC rules will drive capital out of the market and force businessmen out of the industry. These are the seeds of further market distortions the FERC is now sowing. It is our sincere hope that Congress will encourage the FERC to abandon the Block Billing approach.

Senator NICKLES. Mr. Watson, thank you very much.

Our next panelist is Stan Pickens, who is president of Chesterfield Energy Corp., representing the Independent Oil & Gas Association of West Virginia. Mr. Pickens, welcome.

STATEMENT OF STANLEY PICKENS, PRESIDENT, CHESTERFIELD ENERGY CORP., REPRESENTING THE INDEPENDENT OIL & GAS ASSOCIATION OF WEST VIRGINIA, CLARKSBURG, WV

Mr. PICKENS. Thank you, Mr. Chairman, members of the committee:

I represent IOGA of West Virginia today as well as other member associations of the Appalachian Energy Group which represents hundreds of small producers throughout the Appalachian Basin. For upward of 80 years we have provided the consumers in the Eastern United States with a reliable gas supply right in their own backyard. We would like to continue to be a reliable source of gas to these people. We think the block billing will frustrate these goals.

While I will turn to the peculiar problems found in the Appalachian Basin, I first wish to make clear that the small producers plight is by no means unique or isolated and contained in one region.

If you will look at my chart 1, you will see that using the Commission's own assumptions and the EIA nationwide data, the smaller producer is facing a cut in gross revenues of some 21 percent, while the top 31 producers of gas are facing a cut of 17 percent.

Chart 2 shows you why. The smaller producer in this country responded to the incentives of the NGPA so much that some 78 percent of our gross revenues come from wells placed in block 2. Not only are our gross revenues derived primarily from block 2, the volumes we provide are equally impressive. We actually produce 44 percent of block 2 gas, as compared with the 31 top producers of gas, as chart 3 demonstrates.

What is the public policy behind penalizing those who responded to the call of the Congress? How can the rules of the game be changed by a Federal agency with the obvious purpose of avoiding the NGPA? Allow me to use my own region as an example.

The Congress decided in 1978 that a statutory incentive price should be established for stripper wells in order to accomplish two purposes: to keep marginal production on line so as not to waste gas reserves; and to encourage drilling in those geological areas where marginal wells are likely to be drilled. A high percentage of wells in the Appalachian Basin are or will become stripper wells.

The FERC now proposes to place stripper wells in block 2 with the intent of using the new regulations to drive down the price of stripper well gas. Let me first say that Appalachian Basin producers have almost universally renegotiated their contracts downward more than once with their major pipeline customers. Now we are faced with still another move to drive down stripper prices.

It seems almost ridiculous to include stripper wells in block 2. On a nationwide basis, it would raise the average price of block 1 gas by less than a dime to include stripper wells. In sum, 60 percent of the stripper well production comes from the smaller producers, and it seems strange, if not illegal, for the Commission to set out to undermine the decision of the Congress to preserve the price incentives for marginal wells.

But what seems most incomprehensible to us is a conscious decision to discourage stripper wells when the FERC knows that the largest concentration of stripper wells is in Appalachia and that Appalachia is the closest reliable source of gas for consumers in the east.

I am truly hopeful that the FERC will decide not to adopt the block billing proposal, not only for what it does to those in our region, but what it does to the smaller producers nationwide and all other producers and consumers of gas now and in the future.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Pickens follows:]

TESTIMONY OF THE APPALACHIAN ENERGY GROUP

ORAL STATEMENT
FOR STAN PICKENS FOR SENATE

Mr. Chairman, my name is Stanley Pickens. I am President of Chesterfield Energy Corporation. I am here today to represent IOGA of West Virginia, a member of the Appalachian Energy Group which represents hundreds of small producers of oil and gas who drill throughout the Appalachian Basin. For upwards of 80 years we have provided the consumers in the Midwest, the Middle Atlantic, and the Northeast regions with a reliable gas supply right in their own backyards. We would like to continue to be a reliable source of gas for our consumers, good taxpayers for our States, and good providers for our families, our employees, and those dependent on them. We think that Block Billing will frustrate these goals. We respectfully request that the attached comments filed with the FERC be incorporated as part of the record in these proceedings.

While I will turn to the peculiar problems found in the Appalachian Basin, I first wish to make clear that our plight is by no means unique or isolated and contained in one region. The Commission has incorrectly claimed that Block Billing will not harm the small, independent producer. Independent producers, as you know, find most of the new gas in this country and are the vanguard of future gas supply. A look at the latest data available from the EIA will demonstrate that the smaller producer is discriminated against by the Block Billing rule.

If you will look at my Chart One, you will see that, using the Commission's own assumptions and the EIA nationwide data, the smaller producer is facing a cut in gross revenues of some 21% while the top thirty-one producers of gas are facing a cut of 17%.

Chart Two shows you why. The smaller producer responded to the incentives in the NGPA, so much so that some 78% of our gross revenues come from wells placed in Block Two.

Not only are our gross revenues derived primarily from Block Two, the volumes we provide are equally impressive. We actually produce 44% of Block Two gas as compared with the thirty-one top producers of gas, as Chart Three demonstrates.

What is the public policy behind penalizing those who responded to the call of the Congress? How can the rules of the game be changed by a federal agency with the obvious purpose of avoiding the NGPA? Allow me to use my own region, the one that I know best, as an example.

The Congress decided in 1978 that stripper wells should remain under permanent price controls and that a statutory incentive price should be established in order to accomplish two purposes: (1) to keep marginal production on line, so as not to waste gas reserves and (2) to encourage drilling in those geological areas where marginal wells are likely to be drilled. A high percentage of wells in the Appalachian Basin are, or will become, stripper wells.

The FERC now proposes to place stripper wells in Block Two with the intent of using the new regulations to drive down the price of stripper well gas. Let me first say that Appalachian Basin producers have almost universally already renegotiated their contracts downward more than once with their major pipeline customers. Producers in West Virginia have, for example, just completed a major settlement of a long standing case involving stripper well pricing, and the FERC has approved the settlements presented. Now we are faced with still another move to drive down stripper prices.

It seems almost ridiculous to include stripper wells in Block Two. On a nationwide basis, it would raise the average price of Block One gas by less than a dime to include stripper wells. And again, some 70% of the stripper well production comes from the smaller producers.

And it seems strange, if not illegal, for the Commission to set out to undermine the decision of the Congress to preserve the price incentives for marginal wells.

But what seems most incomprehensible to us is the conscious decision to discourage stripper wells when the FERC knows that the largest concentration of stripper wells is in Appalachia and that Appalachia is the closest reliable source of gas for consumers in three regions in the East. I can tell you from personal knowledge that rigs are already being stacked. We think we can beat the geology, but we cannot beat the effect of new federal regulations which say to us, in effect, "don't bother to drill where strippers are likely, because we will change the way pipelines sell gas to make your gas unmarketable."

Maybe this is what the Congress now wants. But it is a definite change from the decision made in the NGPA, and the change is being made by a federal agency, not the Congress. And it hits the smaller producer the hardest. Some will survive and even prosper; others will not. But do not harbor the hope that, if the smaller producer is driven out, the major producer will step in and fill the gap. That may be true in other regions, but not in the Appalachian Basin.

There may be some who believe that gas reserves will be discovered, developed, and produced regardless of what the price is. That kind of thinking led to the curtailments of the 1970's. Some apparently believe that curtailments cannot happen again, yet, in the words of the EIA "During 1984, proved reserves of dry natural gas reached the lowest level in the history of the EIA's estimates." Let me ask this question: will rolling back the price of gas at the wellhead through this new federal regulation increase or decrease the incentive to drill? You know the answer.

I am truly hopeful that the FERC will decide not to adopt the Block Billing proposal, not only for what it does to those in our region, but what it does to the smaller producer nationwide and all other producers and consumers of gas, now and in the future.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Proposed Rulemaking: Regulation of Natural Gas Pipeline After Partial Wellhead Decontrol	)))	Docket No. RM85-1-000 (Part D)

COMMENTS OF THE APPALACHIAN ENERGY GROUP

Pursuant to the Notice Requesting Supplemental Comments ("Notice") issued October 9, 1985, by the Federal Energy Regulatory Commission ("Commission"), 1/ the Appalachian Energy Group ("AEG"), a coalition of associations representing independent oil and gas producers in West Virginia, Pennsylvania, New York and Ohio hereby submit its comments on the Commission's proposed regulations on Block Billing. AEG represents small independent producers engaged in the exploration, production and sale of natural gas and oil in the Appalachian Basin that, for upwards of 80 years, have provided the consumers in the Midwest, the Middle Atlantic and the Northeast regions with a reliable gas supply right in their own backyards.

1/ 50 Fed. Reg. 42372 (October 18, 1985).

SUMMARY OF COMMENTS

I. The Commission Should Not Adopt Block Billing Because Of The Disproportionate Impact On Smaller Independent Producers.

II. If The Commission Does Adopt Block Billing, Stripper Wells Should Be Moved To Block One.

   A. The Congress Has Determined that Stripper Well Prices are Just and Reasonable and Has Further Determined What Portion of the Stripper Well Prices Can Be Removed From Rolled-in Pricing.

   B. Moving Stripper Well Gas from Block Two to Block One Would Result in Only a Slight Upward Adjustment in Block One Gas Costs while Carrying out Congress' Intent of Encouraging Stripper Well Production.

   C. The Proposed Regulation Frustrates Congressional Policy by Undermining the Special Categories Established by Congress for Stripper Wells.

   D. To be Consistent with the Stated Intent of the Commission, the Commission should Place All Stripper Well Gas in Block One.

III. In Answer To The Contention Of Others, If The Commission Decides To Adopt A "Market Sensitive" Block, Then All Contracts Renegotiated Since January 1983 Should Be Included In That Block.

Appalachian reserves require a large number of wells to be drilled in order to produce the underlying reserves in comparison to certain prolific areas in the Southwest and in the Outer Continental Shelf, where single wells may sometimes tap vast reserves. The other side of that coin is, however, that some of the areas which allow a single well to produce large volumes of gas also deplete in a few short years. By contrast, the typical Appalachian well produces at a relatively steady rate for twenty or more years although at a much slower rate. The reliable production characteristics of these wells make Appalachian gas reserves valuable not only to the major interstate pipelines which have historically purchased gas from the region's producers, but also to the numerous industrial consumers and local distribution companies that currently buy gas directly from Appalachian producers. The strategic value of Appalachian reserves should not be underestimated. AEG fears that federal policymakers will overlook the special circumstances of the Appalachian Basin, focusing instead in this surplus supply situation on the economic characteristics of the available production from wells drilled thousands of miles away.

The Commission's Notice is obviously a complex and far-reaching revision of the "rules of the game" for the entire natural gas industry. However, certain aspects of the Notice could have particularly significant effects on Appalachian producers and it is these aspects on which AEG's Comments will focus. AEG trusts that the Commission will consider these Comments in shaping its final rule so that the unique niche occupied by Appalachian producers will not be inadvertently destroyed and Northeastern consumers will not be deprived of the long-term benefits of natural gas produced from viable supplies developed in their own "backyard." The low production rates of these wells make them strong candidates for inclusion in Block One of pipeline purchased gas costs in order to encourage their future development in line with the overall design of the Natural Gas Policy Act of 1978 ("NGPA"). 2/

I.

THE COMMISSION SHOULD NOT ADOPT BLOCK BILLING BECAUSE OF THE DISPROPORTIONATE IMPACT ON SMALLER INDEPENDENT PRODUCERS

The Commission has expressed concern in its Notice over the viability of the thousands of independent producers under the current situation:

"Over the short-term, unless natural gas demand increases, gas markets will fail to 'clear' the current surplus and the United States may permanently lose thousands of independent producers that drill over 90% of the wildcat wells that discover new gas supplies." (Notice at 57-58).

We respectfully suggest that the independent producer will be more adversely affected under Block Billing than under the current situation.

2/ 15 U.S.C. §§ 3301-3432 (1985).

A. According to the late 1985 nationwide PGA data compiled by the Energy Information Administration (EIA), and using the Commission's own assumptions as to the lower range to which Block Billing may be expected to drive prices down, the smaller independent producer is facing a cut in gross revenues of 21% while the top thirty-one producers of gas are facing a cut of 17%. Chart One depicts this data and demonstrates that a disproportionate impact hits the very class of producers for whom the Commission has shown considerable concern.

Chart Two shows why. The smaller producer responded to the incentives of the NGPA, so much so that some 78% of our gross revenues come from Block Two.

Not only are our gross revenues mainly coming from Block Two, the volumes we now provide are equally impressive. We actually produce some 44% of the total volume of Block Two gas as compared with the thirty-one top producers of gas, as Chart Three demonstrates.

If the Commission is truly concerned about the economic survival of independent producers who answered the call of the Congress by seeking new gas supplies, then the Commission should not penalize these producers by severely reducing their revenues associated with new gas supplies. Thus, the Commission should not adopt Block Billing.

B. As this evidence shows, the small, independent producer responded to the price incentives Congress provided in the NGPA and developed the new gas supplies for the interstate market. Now the small producer stands to be the real loser in Block Billing because he responded to the wishes of Congress. Some will survive; others will not. There may be some "classic" theory which says that it does not make any difference if you drive people out of business, because, when supply falls off, the price starts to rise, and new or even old entrants are attracted back into the business. That classic theory may have led to the classic curtailments in the 1970's. But do not harbor the hope that, if the smaller producer is driven out, the major producer will step in and fill the gap. That may be true in other regions, but not in the Appalachian Basin.

C. But there is another important reason for rejecting Block Billing. That is the public policy which would be violated by penalizing those small producers who answered the call of the Congress to develop supplies for the interstate market. Now that they have responded in an impressive way, the Commission should not now change the rules of the game to deprive them of the incentives provided by the Congress. It is a breach of faith.

II.

IF THE COMMISSION DOES ADOPT BLOCK BILLING, STRIPPER WELLS SHOULD BE MOVED TO BLOCK ONE

AEG respectfully submits that the proposed regulation should not be adopted by the Commission. The proposed rulemaking is inconsistent with and expressly contradicts both the Congressional intent behind Section 108 of the NGPA and the Commission's own stated policies. If Section 154.43 is nevertheless adopted, Section 108 gas should be placed in Block One, for the following reasons:

A. The Congress Has Determined that Stripper Well Prices are Just and Reasonable and Has Further Determined What Portion of the Stripper Well Prices Can Be Removed From Rolled-in Pricing.

In Section 601 of the NGPA, [3] the Congress specifically determined that the stripper well price was just and reasonable. The Commission must honor that determination.

The Congress went further and specified what amount of the stripper well price could be taken out of the rolled-in price and placed in a separate account for billing purposes. In Title II, [4] concerning incremental pricing, the Commission specifically set out the kind of Block Billing that was permissible. The Congress went through the NGPA Title I categories and decided which of the categories would be included in what would now be called Block Two and in what amounts. After selecting the categories that could go into Block Two, the Congress set "thresholds", and only the amounts over the thresholds could be assigned to Block Two. According to the late 1985 PGA data compiled by EIA, the stripper well prices on a nationwide basis are less than the Section 108 incremental pricing threshold price established by Congress. Therefore, the Commission cannot place stripper well gas in the second Block and be consistent with Congress' directions in Title II of the NGPA.

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[3] 15 U.S.C. § 3431 (1985).

[4] 15 U.S.C. §§ 3341-3348 (1985).

B. Moving Stripper Well Gas from Block Two to Block One Would Result in Only a Slight Upward Adjustment in Block One Gas Costs while Carrying out Congress' Intent of Encouraging Stripper Well Production.

Initially, the Commission requested comments to "suggest policies or approaches that might better bring rates in line with current resource costs within the relevant legal constraints." Notice of Inquiry, 50 Fed. Reg. 3801, 3803 (Jan. 28, 1985).

With their request in mind, the Commission should remember that the NGPA was adopted, at least in part, to encourage the exploration and development of reserves that were not being developed. A consistent goal must be to continue to encourage development of reserves even in times of deliverability surplus. There can be no doubt that the independent producers developing the Appalachian Basin reserves on marginal economics need some assurances that their production will be purchased in times of over-supply in order to maintain cash flow to investors and capital to reinvest in additional drilling programs. Realigning the stripper well gas from Block Two to Block One would satisfy the Commission's goal and carry out the Congressional mandate of encouraging stripper well production.

Based upon EIA data and our calculations, the transfer of the stripper well gas from Block Two to Block One would result in a minimal impact on Block One gas costs while satisfying Congress' intent of encouraging the development of stripper wells. Over sixty percent of stripper well production comes from the smaller producers, and on a nationwide basis the effect of moving stripper well production from Block Two to Block One would be to raise the Block One price about ten cents to $1.66. No one can argue that $1.66 is above the market price. It is almost a dollar below the price which the Commission chose as the cut-off ceiling price for Block One gas.

Not only is the effect on the nationwide average price inconsequential, but so is the effect on the individual systems of the major interstate pipelines. Since sixty percent of stripper well production is currently found on three pipelines, they will be discussed below. The attached table shows the effect on the remaining systems. (See Chart Four).

The three pipelines are: El Paso, Columbia and Consolidated.

The effect of moving stripper wells from Block Two to Block One on the wellhead purchases of El Paso and Columbia would be thirty-seven cents and thirteen cents, respectively, using mid-1985 EIA PGA data. Because

Consolidated secures around 80% of its supply from other pipelines, it is necessary to examine the entitlements potential from its pipeline suppliers in order to make a meaningful comparison. The assumptions made are shown on the attached calculation, and the effect on Consolidated would be about one cent. (See Chart Five). Thus, we calculate the effect on these systems to be:

	Block 1 As Is	Block 1 with Stripper Wells
El Paso	$1.36	$1.73
Columbia	1.70	1.83
Consolidated	1.89	1.90

While the effect on the consumer is minimal, the effect on the Appalachian Basin producer is significant. In the Appalachian Basin, virtually all the wells produce at stripper well limits after one to three years of production. And if the Commission suggests that the "market price" for gas is $2.50, since that is the cut-off ceiling price implied by the proposed Block One, then the stripper well producer is facing the loss of revenues in the range of 43%, again using mid-1985 EIA PGA data, or 38% using late 1985 PGA data. This result is entirely inconsistent with the Congressional intent of providing an above-market incentive price for stripper wells in order to maintain this marginal production.

Not only should the Commission move the stripper wells into Block One in order to carry out the mandate of the Congress, it should do so by choice, bearing in mind that (1) the impact will fall heavier on the smaller producer, who has over sixty percent of the stripper well production today and that (2) stripper well production is not evenly distributed geographically but tends to be concentrated where the geology is more marginal, such as in the Appalachian Basin and in the San Juan Basin of New Mexico, mainly serving California. Depressing stripper well development thus has a disproportionate regional impact which operates to deprive the consumer of the overall benefit of a local industry. While depressing stripper well prices and discouraging drilling in areas where stripper wells are most likely to develop may be appealing in the short run, the Commission must see that "consumers are provided natural gas at the lowest reasonable rates consistent with reliable, long-term service." (Notice of Proposed Rulemaking, "NOPR" at 3, 50 Fed. Reg. 24130 (June 7, 1985)) (emphasis added).

C. The Proposed Regulation Frustrates Congressional Policy by Undermining the Special Categories Established by Congress for Stripper Wells.

The proposed regulation frustrates the specific Congressional purpose of encouraging production of stripper wells. The Commission stated that "block billing would not result in any inconsistences with the NGPA or any substantial economic inefficiencies." (Notice at 24). Yet, in 1978, the Congress decided that an incentive price for stripper wells was necessary and mandated a maximum lawful price not subject to adjustment by the Commission. NGPA § 108, 15 U.S.C. § 3318 (1982). The Congress provided statutory incentive prices for stripper wells to accomplish two objectives: (1) to keep marginal production on line, so as not to waste gas reserves and (2) to encourage drilling in the geological areas where marginal wells are likely to be drilled. A high percentage of wells in the Appalachian Basin are, or will become, stripper wells. It was Congress itself, not the Commission, which established a specific maximum lawful price for stripper well gas at an incentive rate, and it cannot be presumed by the Commission that the stripper well price is too high or that it is in any way imprudent for the pipelines to buy stripper well gas. As the Fifth Circuit held, "Section 108's purpose is to provide a special price for wells with low production volumes because, absent an incentive price, the revenues therefrom may not cover the out-of-pocket operating costs of maintaining production." Ecee, Inc. v. FERC, 645 F.2d 339, 355 (5th Cir. 1981). Further, Senator Randolph of West Virginia, during the NGPA debates, recognized and supported the need for incentive prices for stripper wells stating that such a provision would "encourage drilling activities." 124 Cong. Rec. S14973 (daily ed. Sept. 12, 1978).

Placing stripper wells in Block Two should, in the words of the Commission, "serve to lower gas prices in the second block and act as a disincentive to imprudent pipeline gas purchasing practices." (NOPR at 51). Either or both intentions frustrate the Congressional policy.

Placing stripper wells in Block Two would destroy the Congressionally mandated incentive to maintain production from marginal wells. These wells will have to be shut in to the point where their maintenance will all but eliminate their value, particularly at Block Two prices in the present gas marketplace. Further, it will discourage drilling new wells and generating new supplies in areas such as the Appalachian Basin where there is significant risk that the wells will become marginal after one to three years of production.

The Congressional policy of price incentives for stripper wells to encourage the exploration and development of marginal production has been successfully realized.

According to the most recent EIA report, the number of producing gas wells qualified under NGPA Section 108 increased from over 44,000 in 1977 to over 77,000 in 1982. DOE/EIA, Drilling and Production Under Title I of the Natural Gas Policy Act, (June, 1984). Total production from wells qualified under Section 108 has increased over the same time period from 233 Bcf to 416 Bcf. EIA Report at 52.

Despite the successful implementation of the Congressional policy to stimulate stripper well production by incentive pricing, the proposed rulemaking would undermine this policy by forcing producers to either roll back their prices or suffer shut-ins because the price of this type of gas would no longer be competitive. By the

Commission's own estimate, it achieved an involuntary price rollback of some $234,000,000 in one year alone as a result of its deregulation rulemaking. (Response of the Commission to Congressman Dingell's letter dated January 1985, Answer to Question One at 3-4). Stripper wells bore about 15% of that rollback. Now the Commission purports to undermine the remaining incentive prices for stripper wells still subject to regulation.

D. To be Consistent with the Stated Intent of the Commission, the Commission should Place All Stripper Well Gas in Block One.

The Commission stated that the division between the Blocks is based on the policy of "reserving to historical customers the benefits of that gas for which the Congress saw fit to retain wellhead price control [in the Natural Gas Policy Act of 1978]." (NOPR at 28).

The Commission has failed to be true to its own stated policy by placing stripper wells in Block Two, despite the fact that the Congress "saw fit" to retain wellhead price control on stripper well gas. To effectuate the Commission's stated policy, the Commission should place all stripper well gas in Block One. (*See* Notice at 39).

III.

IN ANSWER TO THE CONTENTION OF OTHERS, IF THE COMMISSION DECIDES TO ADOPT A "MARKET SENSITIVE" BLOCK, THEN ALL CONTRACTS RENEGOTIATED SINCE JANUARY 1983 SHOULD BE INCLUDED IN THAT BLOCK

The Commission has recognized that there was a recession in gas prices in 1981 and 1982 as well as a downturn in oil prices in 1982 (Notice at 48). Producers who responded to the changed market conditions by renegotiating their contracts thereafter should not be penalized by being compelled to renegotiate again in order to be placed in the "market sensitive" block. (See discussion of "market sensitive" gas in Notice at 63-65).

If Block Billing is adopted, then there should be a Block 2(a) and 2(b), with "market sensitive" contracts placed in either Block 2(a) or Block One. "Market sensitive" contracts could be defined to include any contracts that have been renegotiated as to price on or after January 1, 1983.

Many producers and pipelines have, for the last several years, been renegotiating their contracts as to price, take-or-pay and volumes in an attempt to reflect the market realities of falling demand and prices for natural gas. The Appalachian Basin has not been immune to these changing market conditions as illustrated by the fact that Appalachian Basin producers almost universally have already renegotiated their contracts downward more than once with their major pipeline customers. Producers in West Virginia, for example, have just completed a major settlement of a longstanding case involving stripper well pricing, and the FERC has approved the settlements presented. Now these producers are faced with still another move to drive down stripper prices or face shut-in. Therefore, if Block Billing is to be adopted, to prevent penalizing producers and pipelines who have actively attempted to remain competitive and viable in the marketplace, the FERC should divide up Block Two with market sensitive contracts put into Block 2(a) or into Block One, with all other qualifying gas contracts in Block 2(b).

IV.

CONCLUSION

The Appalachian producers have a substantial interest in the outcome of the Commission's proposed rulemaking. As the EIA data indicate, adoption of the Block Billing proposal harms the small, independent producers, like those represented by AEG's member associations, to a far greater extent than it does the top thirty-one gas producers. Further, the Appalachian producers are located in a region which has a disproportionate amount of marginal production covered by the stripper well category. EIA data indicate that over one-third of the stripper well production in the U.S. is found on the Columbia and Consolidated pipelines, much of which is purchased from Appalachian producers. *See* Draft EIA Aggregation of PGA Filings (unpublished) (May 30, 1985).

The Commission should not adopt Block Billing. If Block Billing is adopted the Commission should afford stripper wells Block One status in order to effectuate the goal of developing long-term cheaper supplies of natural gas and promote the overall goals of the NGPA. In addition, if Block Billing is adopted, then the Commission should recognize "market sensitive" contracts as those renegotiated on or after January 1, 1983.

Respectfully submitted,
the Appalachian Energy Group

Joseph Vanzant
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Association of West Virginia

Pennyslvania Natural Gas
Associates

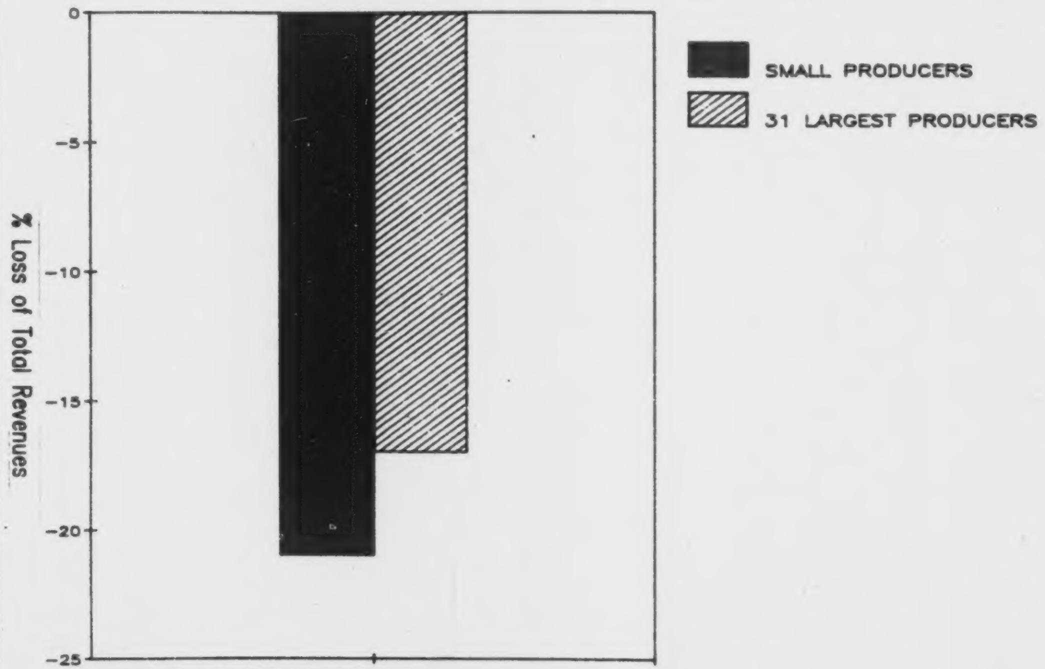
Pennsylvania Oil and Gas
Association

Independent Oil and Gas
Association of New York

Ohio Oil and Gas Association

Dated: November 18, 1985

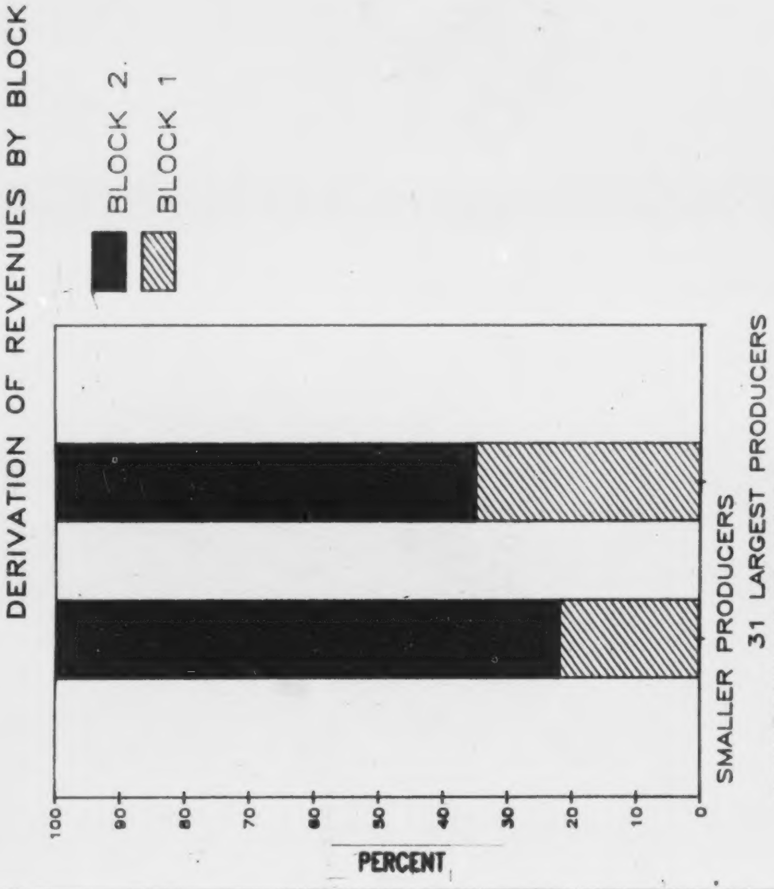
RELATIVE LOSS OF REVENUES
UNDER BLOCK BILLING
AT FERC—PROJECTED* PRICE RANGE



APPALACHIAN ENERGY GROUP
*FERC Notice Requesting Supplemental Comments

Source: EIA Late—1985 PGA Data

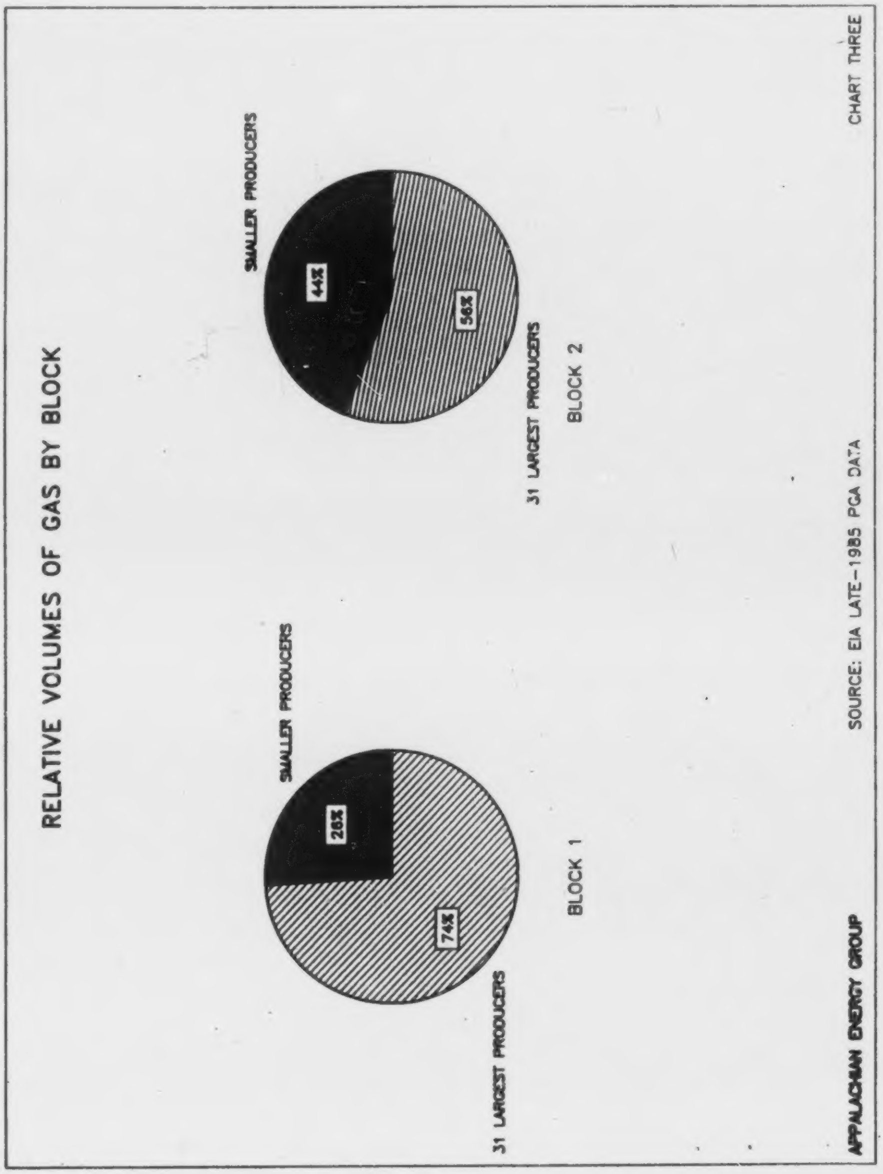
CHART ONE



APPALACHIAN ENERGY GROUP

SOURCE: EIA LATE-1985 PGA DATA

CHART TWO



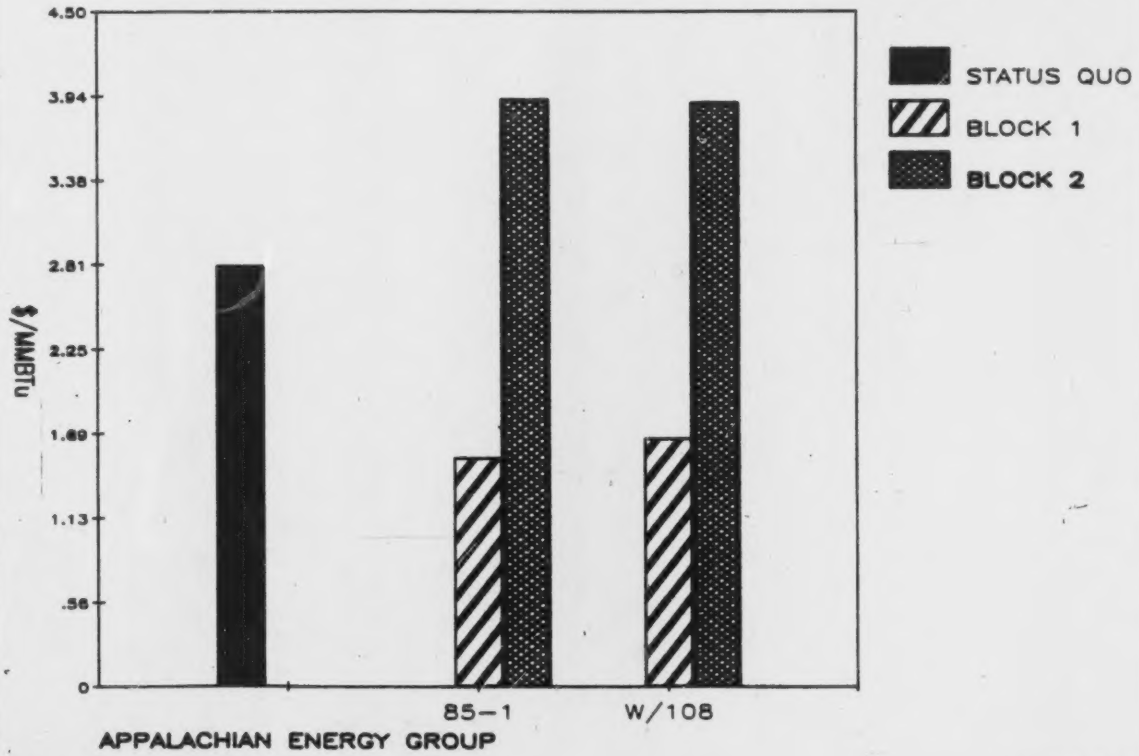
RELATIVE VOLUMES OF GAS BY BLOCK

APPALACHIAN ENERGY GROUP

SOURCE: EIA LATE-1985 PGA DATA

CHART THREE

IMPACT OF SECTION 108 ON BLOCK ONE WACOG



SOURCE: EIA MID–1985 PGA DATA

CHART FOUR

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                                                    November 18, 1985
        SECTION 108 IMPACT ON CONSOLIDATED'S BLOCK 1 WACOG

-------------------------------------------------------------------
BLOCK 1 WACOG UNDER RM85-1 AS IS                              $1.59
-------------------------------------------------------------------

                       VOLUME (Bcf)         PRICE       VOL X PRICE
===================================================================
     BLOCK 1                    35          $1.89             66.15
    BLOCK 1 PPL                418          $1.58            660.44
    SECTION 108                 43          $5.02            215.86
===================================================================
          TOTALS               496                           942.45

-------------------------------------------------------------------
BLOCK 1 WACOG WITH SECTION 108 GAS                            $1.90
-------------------------------------------------------------------
                                                         Chart Five
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Senator NICKLES. Mr. Pickens, thank you very much for your comments, and all of our panelists for your patience, as well. We have several panelists today, and that's the reason why we decided to load it up.

Senator Murkowski, we appreciate your joining us today, as well.

Senator MURKOWSKI. Thank you, Mr. Chairman.

Senator NICKLES. Did you have any opening comments before I ask a couple of questions?

Senator MURKOWSKI. No.

Senator NICKLES. To any of the panel, I am going to ask questions first on transportation, then on block billing, and then on possibly DOE's order or legislation.

Mr. Hentschel I'll direct this toward you, if possible: We are having a hard time trying to analyze how much gas is actually shut in as a result of lack of participation by pipelines. How much spot gas is not finding or moving in the market today that was prior to November 1?

Do you have a feel for that figure in determining how much gas is not moving today as a result of that order?

Mr. HENTSCHEL. Senator, I can't speak in terms of the overall industry. I can speak in terms of my own company. In effect, if I go my average production for the year prior to the implementation of the order on November 1, one-sixth of my production is shut-in.

Senator NICKLES. One-sixth?

Mr. HENTSCHEL. One-sixth.

Senator NICKLES. Are there any of the other producers or organizations that could give us another figure?

Mr. **Harrison**. I can give you a figure for Exxon U.S.A. Insofar as this particular transportation order is concerned, we were moving 260 million cubic feet per day of gas under transportation arrangements prior to November 1, and afterwards we've had to shut-in 60 million cubic feet per day. We have worked out transportation arrangements and sales arrangements to continue 200 million of the 260 million under sales at, in some cases, differing prices and different arrangements.

Senator **Nickles**. Mr. Hentschel?

Mr. **Hentschel**. Let me clarify something, Senator. When I said I had 100 million moving through the transportation through special marketing programs, zero of that is moving today.

Senator **Nickles**. So you've lost 100 percent of your spot?

Mr. **Hentschel**. That's right. That's exactly right.

Senator **Nickles**. Spot gas.

Mr. **Hentschel**. And that represents one-sixth of my total.

Senator **Nickles**. One-sixth of your volumes.

Anyone else care to weigh in on that? Because one of the problems that I have really seen, and maybe I'll go into the cause of that problem. Mr. Nelson, did you want to comment?

Mr. **Nelson**. Well, I wanted to quote some statistics.

Senator **Nickles**. Go ahead.

Mr. **Nelson**. We were moving on nontraditional—through nontraditional channels about 410 million a day out of a 2 billion total production a day. We're now moving about 370 of that 410, but we're moving it through traditional channels, obviously at quite a bit higher prices than we were moving the 410.

Senator **Nickles**. Through the spot.

Mr. **Nelson**. Yes.

Senator **Nickles**. I have told various FERC Commissioners my objection to the contract demand reduction provision, the 25-percent reduction which is a condition for the pipelines if they want to participate, which is for a lot of reasons, but primarily on a contractual basis. And, too, I don't see that the FERC has the statutory authority to give one entity a right to abrogate a portion of their contracts.

Is there anyone in this group who would disagree with the statement that that provision, that 25-percent reduction, hinders participation and therefore hinders movement of gas into the spot market?

[No response.]

Senator **Nickles**. Does anybody think that that portion of the rule should be maintained, that portion of part A that deals with contract demand?

[No response.]

Senator **Nickles**. So it would be unanimous on the panel. I appreciate your comments.

I've got several kind of quick questions, and then I want to turn to my colleagues as well. On block billing, I think I heard everyone state their opposition to block billing. Is that correct? Block billing, as modified? Let me ask you a question. We are going to have a panelist in a moment to come up—and I've heard people say, well, we used to roll in prices and now we can't, if we did it would give one group an advantage over other groups, and I agree with those comments.

We'll have a panelist in a moment that will come up and say, well, this will save consumers $5 billion a year. Do you all agree that that will save consumers $5 billion a year?

[The panelists nod in the negative.]

Senator NICKLES. I see some shaking heads. Mr. Watson?

Mr. WATSON. No; I disagree. As I said in my testimony, under the rolled-in pricing you get an average. Under the block billing pricing that FERC has proposed, yes, there'll be a $3.3 to $5 billion reduction that will come out of the hide of the producers, but there's no guarantee that it's going to get to the consumer, because FERC does not have jurisdiction over these utility companies that will be getting these entitlements of block 1 gas.

Senator NICKLES. Mr. Eck, I saw you——

Mr. ECK. I thoroughly agree with that statement. There is absolutely no assurance it will flow through to us. This is a short-term bargain with the devil that you get perhaps $5 billion in the first year or two, but ultimately it's going to cost $10, $15, or $20 5 and 10 years from now to replace that gas that's going to be lost through this block billing system.

Senator NICKLES. So you think in the long term it would not be in consumers' interest to have the block billing proposal go forward?

Mr. ECK. I think you're going to pay $3 for every dollar you save.

Mr. HENTSCHEL. I don't even think—Senator, I don't even think it has to be on a theoretical basis as to whether it flows through. The current system shows you it doesn't flow through. Mr. Eck showed charts where you've had a substantial reduction in the purchased gas costs, and at the same time somebody indicated that the residential price has actually gone up. So in effect the reductions in purchased gas costs have not flowed through.

So to say that they would is kind of an overstatement of actual performance.

Senator NICKLES. Mr. Holland?

Mr. HOLLAND. I would like to just add to the statements. One, we have noticed by Mr. Eck's charts, purchased gas costs have come down. I don't think that there's any disagreement that the block billing as has been proposed may give this short-term reduction. But when you see the decline that has existed before this was ever implemented, and you then put a further decline in price on the basis of this, you've got to weigh what the consequences are of this price reduction. It's going to have a very significant impact on the future reserves of this country, and somewhere we have to face up to this. It's just short term.

Senator NICKLES. Every one on the panel represents a producing segment, as well. If block billing did go forward, would you actually reduce production from what you're producing today? Is that correct? Tell me if you disagree?

Mr. WATSON. Not only reduce production, but more importantly reduce exploration.

Senator NICKLES. That's what I mean, exploration.

Mr. HARRISON. Mr. Chairman, I wanted to add a comment on the block billing to emphasize the supply effects. This block billing would be imposed and have an effect on the block 2 gas prices pushing them down at a time, and eliminating the roll-in to some degree, although there would continue to be a roll-in in each block. But it would be an effect taking place in a time when the market is in a very changing situation, with gas prices dropping very, very rapidly as shown by the chart previously.

We market a substantial part of our gas in the gulf coast part of the States, insofar as industrial sales go, and those spot prices have dropped from something almost $3 per million Btus at the start of this year, to almost $2 now, a very substantial drop in gas prices. This is causing drilling to drop off. This discussion of supply is not a theoretical and imaginative point.

Drilling for gas has dropped substantially since 1981, and is down from about 20,000 wells per year to 16,700, and in the year 1985 drilling has declined even further. It's down another 5 percent so far this year. The effects of this dropping price in gas has not been fully reflected, I don't believe, in the drilling.

I think significantly further drops in drilling are going to take place. In our particular case, we've recently been reviewing our 1986 drilling plans, and we have reduced our plans for gas drilling in 1986 by about 20 percent over what we had previously anticipated. We've also cut back an even greater amount on our gas exploration.

Now we resisted those changes for a long, long period of time. But in the face of this particular change in the market, at which time the gas prices today are less than replacement costs for the gas that you're selling, eventually you just have to respond. We are responding.

Now you impose upon that particular situation a block billing situation which arbitrarily puts additional pressure on block 2, not to say anything about all of the inequities it's created, you're going to have a supply effect. It's going to be major, and it's going to take place sooner rather than later. Now I don't know when, and I don't think anybody does, but it's going to show up.

Senator NICKLES. Thank you. I have some additional questions, but I don't want to monopolize the time.

Senator Rockefeller, you've been in here for a long time. Do you have any questions?

Senator ROCKEFELLER. Mr. Chairman, I don't know whether Senator Ford or Senator Murkowski have statements they'd like to make?

Senator FORD. No, I have no statement.

Senator MURKOWSKI. I have some questions when you're finished.

Senator ROCKEFELLER. If I might, Mr. Chairman, just restrict my questions to Mr. Pickens from West Virginia; Mr. Pickens you make a point of not only the proximity of Appalachia to the East, but the particular nature of the Appalachian Basin in your testimony—what is the difference? How would you describe the difference between the stripper gas well in the Appalachian Basin, and those wells in the West, for example, the Southwest?

Mr. PICKENS. The stripper well classification would be the same in the Appalachian Basin as in the West, Senator. However, we happen to have 98 percent of our wells in the Appalachian Basin are stripper wells. So we provide about one-third of the stripper well gas production in this country in this small area of West Virginia, Pennsylvania, Ohio, and Kentucky. So we're very pinpointed as far as the type of production we have there.

Senator ROCKEFELLER. Is there a difference with respect to when the return from the drilling or the volume occurs, earlier years, later years, that kind of thing, as between an Appalachian Basin well and a Western one?

Mr. PICKENS. Yes, sir. In fact, the Congress in its wisdom when they did the NGPA in 1978 recognized that our particular area did not have the large open flows of gas or the quick cash flows that our wells and our resources were very long lasting. The average well in Appalachia will produce from 25 to 50 years. And recognizing this, they gave us the incentive with the NGPA to go and drill and produce those, and to give us a fair return on capital, which is what I said in my testimony we did, and now we're getting it the other way after we've performed as we were asked to do.

Senator ROCKEFELLER. When you drill an average well in the Appalachian Basin, about how deep would it be, and about how much would it cost to drill it?

Mr. PICKENS. Well, our average depth of drilling in the Appalachian Basin is somewhere between 3,000 and above 6,000 feet. We have a few wells drilled below that. So in most areas of the country, that would be considered shallow-well drilling. As far as the average cost, I can only speak for my own company on that basis, but we are somewhere between $45 and $50 a foot to drill and produce a well at that depth.

Senator ROCKEFELLER. All right. Now with that in mind, and getting back to the question of return with respect to the volume of gas, what would you in an Appalachian Basin typical well, would you get let's say in your 1st year in volume—I'm trying to establish a pattern here—as opposed to let's say your 5th year or your 10th year, presuming it was operative?

Mr. PICKENS. Well, our normal decline in production in the first year will probably be somewhere between 12 and 20 percent. Then probably another 10 or 15 percent in the second year. Then after that, a very slow rate of decline, probably in the 3 to 5 percent range thereafter.

Senator ROCKEFELLER. Would that differ from your non-Appalachian Basin well with respect to the return on volume?

Mr. PICKENS. Yes, sir. The volume in our wells perhaps is as high as in some of the Southwest production. However, because of the type of geological formations that we have which would be considered tight sands in some areas of Devonian shale, et cetera. It takes us many, many more years to recover the same amount of reserves as it does in the Southwest.

Senator ROCKEFELLER. Not that you can answer it now, but for the record would you supply this committee with some employment information. There are 6,000 to 6,500 people in West Virginia who are employed directly or indirectly in the oil and gas business. Could you supply for this committee and for me the effect of the 29 county flood devastation on any employment and on any wells, equipment, job loss, or anything of that sort, the flood that we've recently been through? I don't expect you to answer that now.

Mr. PICKENS. It will take some time, but we will provide that for the record.

Senator ROCKEFELLER. I understand that. But perhaps through your association, you could supply that kind of figure.

Mr. PICKENS. Yes, sir.

Senator ROCKEFELLER. Not only people dislocated from work, but equipment, that kind of damange.

When you're looking at the characteristic of a well and you're making a business decision as to whether to go after it or not, you have to look at your costs—both before and after it's drilled. You've got personnel costs, you've got equipment costs, and at some point you have to get a certain amount back in volume, I'm not talking price here, but you have to get a certain amount in volume; and at some point the marginal cost of equipment and personnel are going to cross, either favorably or unfavorably, with the volumes you are producing.

How do you describe that situation in Appalachian Basin wells?

Mr. PICKENS. Well, the way it is sitting now, Senator, if prices continue to go lower than they are, there's going to be a lot of wells in the Appalachian Basin that are prematurely abandoned, which is going to go directly against what Congress tried to do in the NGPA, because a well in the Appalachian Basin that would seem so nominal in production of say 5 mcf of gas a day, or 150 mcf of gas a month, would provide heating for approximately 30 homes. And to operate those wells and keep that reserve, and those reserves may be produced for 50 years, once you abandon that, you're never going to go back into that well because the volumes are so low it would be entirely uneconomical.

So therefore, to keep those reserves flowing and guarantee that energy supply to the people in the East is exactly why the Congress, as I said, in its wisdom developed the NGPA in 1978, to make sure that those marginal wells did stay on production, and that the small independents received enough money for those reserves to keep those wells in production and that gas flowing.

Senator ROCKEFELLER. Mr. Pickens, if FERC continues to go ahead with this block billing proposal, and if you're looking at 6,000-6,500 jobs direct and indirect, and you're reflecting, as all the panel members have, about the effect of that proposal with respect to drilling of new wells, maintenance of those in operation, what would you think would be roughly the percentage of wells that would close, stay closed, and stay closed permanently, be shut in. No. 1, of those now operating in Appalachia.

And then second, what would you induce from that would be the job loss involved?

Mr. PICKENS. Senator, it's difficult for me to give you an exact answer on the first question, how many wells would be abandoned.

Senator ROCKEFELLER. A rough percentage.

Mr. PICKENS. I'll say this, that our drilling activity is down already 35 to 40 percent.

Senator ROCKEFELLER. Understanding that, and knowing that, in continuation——

Mr. PICKENS. Well, if the prices keep going down, we are at the uneconomic level in many of our wells already, and we feel that if the prices go down below the $3 level, that there's going to be very, very high abandonment numbers in the State. The exact numbers I can't give you.

Senator **Rockefeller**. Thirty to fifty percent? Fifty percent plus?

Mr. **Pickens**. It could be up to 50 percent.

Senator **Rockefeller**. Up to 50 percent?

Mr. **Pickens**. Yes, sir.

Senator **Rockefeller**. Is there a corresponding relationship—although there's some variation in employment with respect to each sort of different operation, and wells, and companies—is there a corresponding employment result?

Mr. **Pickens**. Well, speaking for my own company, Senator, and I've already had to make some contingency plans, if the prices keep going down and we have to stop drilling, I now have 22 employees, and we will have 6 in the company if we can't continue to drill.

Senator **Rockefeller**. Thank you, Mr. Pickens.

Thank you, Mr. Chairman.

Senator **Nickles**. Thank you, Senator Rockefeller.

Senator Murkowski.

Senator **Murkowski**. I want to commend you, Senator Nickles, for holding these hearings. I think the witnesses, as evidenced by their testimony, have certainly put before us another one of the traditional enigmas that this committee faces from time to time. I'm reminded of the discussion and debate that we've had on synfuels when one of the gentlemen said, I think, that we're going to pay $3 for every $1 we save. The same application I think is true in synthetic fuels from the standpoint of what we can anticipate in the future if indeed the realities dictate that we are going to be short of oil and gas at some future time. We should be addressing this issue, and we have attempted to address it at a time when obviously the cost of synfuel experimentation and advancement continue to go up and prices decline.

I guess my concern is that the general consumer and his advocates live today, as opposed to what necessitates planning for tomorrow. And I'm a little concerned with the statement that was made by one of the witnesses, Mr. Chairman, that the companies would not have to take the old gas, in effect, they wouldn't take it. But if you have a declining market, which we're in now, and you have to compete with other fuels, and assuming those other fuels go down, don't you in effect have to take the cheaper old gas to remain competitive with other fuels? You know, if you don't, then how can you be competitive?

Anybody?

Senator **Ford**. Say it again.

Senator **Murkowski**. You want me to say it again?

Senator **Ford**. Yes; I thought the answer was up there.

Senator **Murkowski**. I won't direct it to Mr. Eck, but I'm told that——

Mr. **Eck**. I'll answer. I agree with your position that in all probability there will be an accelerated depletion of the old gas reservoirs, and that's what we've found. We're depleting the old gas reservoirs without getting any of the benefits of increasing production or maximizing yields, as Mr. Nelson referred to as our potential.

That's really what's wrong with block billing, and what's right with the Department of Energy approach to dealing with old gas.

Senator MURKOWSKI. Well, that really didn't answer my question.

Mr. HENTSCHEL. Let me try it, Senator.

Senator MURKOWSKI. My concern is an obvious one. Assuming the market continues to decline and you're going to have to remain competitive with other sources of fuel, aren't you going to have to move old gas?

Mr. HENTSCHEL. Well, the fact is, there is an economic limit at which you reach where in effect you can't produce it. So if the price does not go up and you're required to do some remedial work in terms of drilling additional wells, or whatever, to produce those reserves and the market price won't justify it, then that gas is no longer—is not produced, and in effect it's shut in. And it's been estimated, I think by some of these studies, that under that condition you could see 25 to 35 trillion cubic feet of gas shut in because it's uneconomic.

Senator MURKOWSKI. Well, I understand that, and I think that point has been made by the witnesses as well as in conversations I have had with some of the witnesses. But my point is, if you're going to remain competitive with alternative fuels, aren't you going to have to pull out that old gas, assuming the market continues to decline?

Mr. NELSON. Senator, I didn't answer earlier because I didn't make the statement that the old gas wouldn't move, but indeed we——

Senator MURKOWSKI. I didn't indicate anybody had made the statement.

Mr. NELSON. Indeed, we see in the field that the old gas is preferentially held back. And the reason for that is very obvious: It's another one of the messes created by all these various prices. For a smart pipeline company to keep its take-or-pay at the lowest level, then it will preferentially shut in old gas.

It's also a pork barrel sitting out there, and each of them use it in a different way as they perceive the market, and depending on their need to stay in the market today on their future need for old gas. But it's going to be called on to the maximum, we think, within the timeframes included in our study.

Senator MURKOWSKI. So is it fair to judge, then, from your statement that you feel that indeed you have to take old gas, assuming the market declines and you have to remain competitive?

Mr. NELSON. Oh, yes.

Senator MURKOWSKI. So the statement that was made earlier that you don't have to take old gas is not necessarily true, assuming that there's a continued competition among fuels in the sense of a declining market?

Mr. HOLLAND. Senator, if I may, I'd like to comment on that. I think that to keep—you make reference to alternate fuels, and certainly natural gas has to compete against alternate fuels. But the situation today is such that I think many of us here at this panel would be delighted to get alternate fuel price for some of our gas.

The problem is that we have what's called in the industry "gas to gas competition." This comes about for various reasons that perhaps are different for each producer. But speaking for our own company, Mobil, I can say this. The statement was made earlier that gas, when it started being sold for less than you can replace it, you've got to sit back and decide whether or not you want to sell it; because I think the time is coming—it's very difficult to pinpoint it—but the time is coming where we're not going to have the deliverability to meet the needs for the natural gas consumers.

Now when that time comes, there's going to be a change, and I think we're going to see then that natural gas is going to compete with alternate fuels. And as far as our company is concerned, we have a deliberate plan in our near-term expenditures to not spend it for natural gas exploration or production where we have that flexibility.

Now to the extent that's being done by other producers, you're going to have to reduce the future supply until things become more motivated toward developing new reserves. I think that in the long term, that natural gas being somewhat of a premium type of fuel, that it has environmental aspects that are probably better than any alternative of residual, or nuclear, or some of the others—perhaps not solar—but certainly it's a premium fuel; and so at some point in time, I think you're going to see the price of this gas move toward its preferential premium market. And if you want my judgment, it's going to be somewhere between the alternate fuel value of No. 6 and No. 2 heating oil.

Senator MURKOWSKI. My last observation is a point that was made by some of the witnesses predicting further declines in exploration drilling, which I would only assume would be an aftermath of a declining market. There's nothing unusual about it. It's the tradition that you cut down your exploration and development when there's a decline in price and plenty of the product around, and you pick it up when it's going the other way. So, really, what's so unusual about that acknowledgement?

Mr. PICKENS. Senator——

Mr. HARRISON. It is not—excuse me.

Mr. PICKENS. Go ahead.

Mr. HARRISON. It's not unusual. It's a normal thing. My comments on that were merely to reflect that to establish that background on which block billing is now being considered to be sure that we're in a back—we do have a background where the market is dropping, where there is going to be adjustments to be had. That's normal.

We do have a surplus producing capacity now. From my perspective, I would emphasize to you that that is a surplus in capacity. It's hard for me to view that as a surplus situation of reserves when our lower 48 gas reserves have declined from 291-or-so trillion cubic feet the year ending 1970 to 163 trillion cubic feet year-end 1984, more than 40 percent less reserves operating on 9 years' supply, and to view us as having a big, big surplus supply in a longer range conception is a little bit hard for me.

Now we do have a surplus producibility today. The market is falling very rapidly, and you're normally responding to it. It is a normal situation. I agree.

Senator MURKOWSKI. What I'm getting at is why is this thing in a sense unusual because it's moving one way as opposed to the ability of the industry to respond when, as you predict—and I certainly agree with you—it begins to move the other way? Could we not have been in a situation here 3 or 4 or 5 years ago when we had basically a speculative market in energy exploration as a consequence of the declining price? We saw a lot of energy companies go under and not be able to handle their debt service. So aren't we seeing just a natural reaction of the marketplace, the give and take, the decline in price, the lack of incentive for exploration? And, as you predict, once the shortage process begins, we climb up the ladder again.

Mr. **Harrison**. If we get decontrol, that'll help the market work better.

Senator **Murkowski**. Well, you'll get decontrol, in my opinion, as soon as the industry can get together and come before this committee and some others around here with one voice. I happen to be one member who sat through I don't know how many, 30-some-odd hearing days, and there was no consensus from the industry group. And until there is, why there's not much we can do. That is an editorial comment.

Mr. **Hentschel**. Well, the one thing, Senator, I would say is exploration is an activity that is very difficult to turn on and off and get a quick response. The difficulty is that in the interim between the time that you want to turn it back on and see the results of it, in this particular market you're subject to the incremental requirements being satisfied from foreign oil, foreign products, and in a situation where the country is in a bad deficit problem, it does nothing but exaccerbate that problem.

Senator **Murkowski**. Well, thank you for the time, Mr. Chairman. I think it's the type of discussion to reflect on the appropriate market fluctuations and is something the committee should consider, as well.

Senator **Nickles**. Senator, I appreciate your comments. I might just add an editorial comment. The purpose of today's hearing—I don't think we've heard any panelist say, just bemoaning the fact that the price of energy, gas or oil or whatever, has declined; but part of the new problem that we find, in addition to a market that's depressed, we have FERC rules right now that's shutting in gas. Is gas shut in in West Virginia today because of this FERC ruling on transportation?

Mr. **Pickens**. Senator, only about 15 percent of our gas in the State of West Virginia is in the spot market area. About 85 percent of our gas is already committed by contract to the interstate pipeline.

Senator **Nickles**. We're finding a very high percentage of gas in a lot of States is being shut in. And again, that's not due to market forces; that's due to the FERC's ruling and the block billing proposal could even aggrevate that further. So that's what we're contemplating today. There's no doubt that we've had a decline of drilling and will continue to as prices and the market is soft. But it's even much more obvious that people aren't going to be drilling. If they're selling—we have a lot of producers in our State that sell extensively in the gas spot market, and that market has been closed.

Therefore, they have gas right now that they can't sell. They're not going to go out and drill for any new gas. So we're really trying to focus on FERC's ruling so they don't further depress an already declining industry.

Senator Ford, we're pleased that you're with us today. Do you have any questions or comments?

Senator FORD. I've a question or two, and I'm delighted you're pleased I'm here. [Laughter.]

What I'm hearing from the panel I've heard for a long time. I'm not from an oil or gas producing State, but we do have some, but I have coal, and we've had a lot of surplus capacity over the years, and I understand what you all are saying today. My coal producers have been in this position for the last 30 years, and we now have 20- to 30-percent coal capacity shut in. So I understand that.

Mr. Watson, when the chairman asked you a question a moment ago, or you responded to one of his questions as to the saving to the consumer of $3 to $5 billion, you made a statement about coming out of somebody's hide, and that sort of thing. Would you reiterate that statement for me, please?

Mr. WATSON. Yes, sir, I'll attempt to.

Some of the studies that have been filed with the FERC in this proceeding have estimated that the wellhead, the price to the consumer, the wellhead prices will be reduced in a manner that will amount to from about $3.3 billion to in excess of $5 billion. I believe that's over the first year. That in effect would be coming from the producer, from the producing segment of the industry.

And under FERC's proposed block billing concept, those moneys would theoretically be passed all the way through, except for the fact that there is no guarantee that it will ever go all the way through; because, under their block billing concept, they're proposing to isolate all of the old, lower priced gas into block 1, and give that entitlements that the interstate pipelines now enjoy, cause them to, instead of averaging that gas with their new gas purchases, they have to isolate it and sell it to their historical customers.

So the interstate pipelines who over the years have negotiated these contracts to get title to the right to purchase this low priced gas, are now having to give that entitlement along to their purchasers, to their historic purchasers, and the FERC has no jurisdiction over those purchasers.

So there's no guarantee that that gas—that that saving is going to be passed on to the consumers, to the man on the street.

Senator FORD. You mentioned utilities in that. I thought we usually had a fuel adjustment provision, that when the prices of fuels go up, it was adjusted to pay a little more, and the prices go down it was adjusted. That indicates that reduction or increase would be passed on to the consumer. Isn't that correct?

Mr. WATSON. Well, they do have a purchased gas adjustment clause, but when you isolate the block 1 gas—and I'm not by any stretch of the imagination a rate expert for utility ratemaking—but as I understand the way FERC has structured this thing, the price on the block 1 gas is not going to necessarily go down. The savings that we're talking about is going to be caused primarily by the artificial pressure that is put on the higher priced gas, the incentive gas, the stripper gas, the new gas, and the decontrolled gas.

Senator **Ford**. But the thing I wanted to try to get cleared up here is that every public service commission I know, and I have had some knowledge of that, that they have the fuel adjustment clause. So if the fuel prices are down to that utility, they are required by law to reduce it, just the same as if the prices go up, they pass that on. Your bill may be consistent as it relates to capital charges, but the product that you transfer fluctuates, and that's where your bill has been increased in the past, when your gas went up so high, as Senator Murkowski was talking about awhile ago, now the market is down so we ought to see somewhat of a reduction in that fuel adjustment.

So the question in your mind is the artificial suppression, or whatever that might be. That's your problem. But when you start saying the consumers won't receive that, I think by a fact of law they have to receive any reduction in the fuel cost to the utility.

Mr. **Watson**. Well, to some extent I agree with you, Senator. But if that's true, then why has—the price of gas over the past year has dropped significantly at the wellhead, yet the price to the homeowners in Boston and in the East and in the Midwest has not decreased. Now why is that? If the wellhead price dictates the burnertip price, there's been a long lag, and the price is about the same and, in some cases, they have increased to the homeowner.

Senator **Ford**. Well, Mr. Watson, if this block 2 proposal goes through, we'll see a lot of pressure from the consumer.

Let me ask a question here that's been bothering all of us for a long time, and I want to start with you, Mr. Eck, and then I guess I'll go to the left.

If a pipeline were to accept open access—that's part of the problem we're facing here today—and I gather from your testimony—I wasn't here to hear it, but I have scrutinized most of the testimony—that you're apparently in favor, would you be willing to waive all take-or-pay and other liabilities which accrue by reason of the pipeline opening its system?

Mr. **Eck**. Well, let me tell you the deal that some of the pipelines are trying to put across. That is——

Senator **Ford**. I'd like for you to answer my question instead of trying to criticize pipelines.

Mr. **Eck**. Well, let me tell you. The answer is, we're not going to take the deals that most of them are proposing, because to put 1 mcf through the line, is to renounce all contracts.

Senator **Ford**. I take it your answer is no, then?

Mr. **Eck**. The answer is, every deal is negotiable. We just got through negotiating the biggest deal in our history with Columbia Gas. We got together, and the net result is a good deal on both sides and we're going to ship more gas.

Senator **Ford**. And the Columbia laid its net worth on the table and you took it. [Laughter.] I know something about that. [Laughter.] Now, Mr. Nelson, what about you?

Mr. **Nelson**. No.

Senator **Ford**. No?

Mr. **Nelson**. No.

Senator **Ford**. All right. Mr. Holland?

Mr. HOLLAND. I think we're always prepared to go to the negotiating table, but we are not prepared to unilaterally give up a take-or-pay obligation on the part of our existing purchasers under a contract just to have open access to the transportation.

Senator FORD. Mr. Harrison?

Mr. HARRISON. Our answer is no.

Senator FORD. Mr. Hentschel?

Mr. HENTSCHEL. Is the question concerning a forgiveness of everything to date and everything forward?

Senator FORD. Well, that's my question. Would you be willing to waive all take-or-pay and other liabilities which accrue by reason of the pipeline opening its system?

Mr. HENTSCHEL. No.

Senator FORD. Thank you, Mr. Chairman.

Senator NICKLES. Thank you, Senator Ford.

Senator Bumpers?

Senator BUMPERS. Mr. Chairman, I am probably the least knowledgeable on this issue as anybody sitting around this table. I have not followed the hearings as carefully as I perhaps should have. But I want to say to Mr. Watson and Mr. Hentschel both, that No. 1, I'm ambivalent on this for two reasons.

One, I would like to see the consumers get the benefit of whatever the ruling might be.

Two, I have strong difficulties with the rule, as Mr. Hentschel has pointed out in his testimony, related to the sanctity of contracts. I don't like the idea of violating that. I am a lawyer, and I was taught that contracts between consenting adults ought to be honored. If one party is perhaps unfairly advantaged, why that's the way our system works. So I have a problem with that.

No. 2, I'm not going to vote for anything that I think has a deliterious effect on exploration, and I'm not at all sure this proposal is not going to do exactly that. We've got rigs stacked up in my State galore that are not drilling, and they're what I consider to be some hot properties in my State that ought to be drilled right now. But I think, based on a part of this at least, there's a serious disincentive to exploration.

Now the other thing is, of course under the Gas Act we've created all these categories of gas prices, and if there were a free market at work, then this would all make a lot of sense. But to take the artificially fixed prices which Congress essentially set under the Natural Gas Act, and then say we're going to force the industry to do block billing instead of the traditional rolled in billing, I think is also something of a disadvantage to them.

And finally, I think regarding Senator Ford's questioning so far as these lower prices being passed on, I agree with Mr. Watson. It's sort of like beef. I used to be a cattle farmer, and I'd take my cattle to market, and the price would be down. And I'd go to the grocery store, and the price of beef was up.

It seems to me that we have a situation similar here. I suppose Senator Ford is correct that every State has a fuel adjustment clause provision in their billings, but the lower prices don't ever seem to be reflected. The price of natural gas is down dramatically from what it was a few years ago, but that has not been reflected in anybody's gas bills at the residential level that I know anything about.

So let me just ask one or two questions. If this block billing rule is going to become a fact, and if you in fact see producers losing $3 to $5 billion a year, what kind of a price would it take for the FERC to set to offset that to make it palatable to you? Or have you given that any thought?

Mr. NELSON. You're speaking to the just and reasonable?

Senator BUMPERS. Yes. Exactly.

Mr. NELSON. We would think it should be some surrogate of the market, and just how that'd hone in on that, we don't know. We'd expect them to be a little below maybe what we might consider true market clearing, but if you've got to have a number, I'd say something in the range of $2.40 or $2.50.

Senator BUMPERS. Rolled in price, you're talking about for all gas?

Mr. NELSON. I'm talking about the just and reasonable prices.

Senator NICKLES. He's talking about old.

Mr. PICKENS. Senator, could I respond to that also, sir? Speaking for the Independent Oil & Gas Association of West Virginia, we were very pleased that the DOE in their proposed rulemaking recognized——

Senator BUMPERS. Mr. Pickens, pull that microphone over a little bit and start over again. I'm sorry, I can't hear you.

Mr. PICKENS. The proposed DOE rulemaking that they have out, we were very pleased to find that they agreed with Congress in their action in the NGPA in 1978 that the national supply of the marginal and the stripper well production was to maintain those incentives. And also to get rid of these artificial ceiling constraints. We're pleased with that portion of it. It seems like this is taking the step toward deregulation, and we are very much and have been in favor of that, and we think that that is probably going to do more for the marketplace than anything else.

Senator BUMPERS. Let me ask you a question. Maybe, Mr. Eck, this question ought to go to you. It is essentially an economic question.

What are our present reserves? What are we finding each year? Are our total reserves declining? And if so, why is the price continuing to decline? Is this an immediate problem?

Mr. ECK. Yes, sir. The natural gas reserves of the United States have been steadily declining since 1970. Last year, we replaced something like 75 percent of the gas we produced, which says of course we didn't replace 25 percent of it.

This year, our judgment is that due to the sharp reductions in drilling, and particularly drilling for gas wells—you know, we heard that companies are preferentially not looking for gas; if they're drilling at all, they're looking for oil. So we're envisioning a year 1985 when reserve replacements likely would be in the neighborhood of 12 tcf versus production of 18, and we may be optimistic on reserve replacement.

So we're starting out with a situation where we're already way behind. And if we just impose block billing, we'll get down into a world in which we're absolutely assured of a massive gas shortage sooner rather than later. And that's just the basic economics of the problem we face in this business.

Senator **Bumpers**. Do you have any projections as to when this shortage is going to begin to hit in the marketplace? That is, when is the price of gas going to begin to start going up?

Mr. **Eck**. Well, my general judgment is that the market now is fairly close to this period of transition. I think there has been a basic misperception of very recent origin that has permeated the market. That is, the judgment that there's just an immense amount of cheap Canadian gas. So somehow pipelines can play off cheap Canadian gas for United States and somehow ratchet the market down. And that's just wrong.

Canada has essentially the same replacement cost economics as we have in the United States. They have to import oil. They pay actually more for their oil imports than we do. Drilling up there, they're running out of cheap gas wells just like we're running out of cheap gas wells. So it's just wrong to assume that massive amounts of cheap Canadian gas is going to come to this market.

And once the market becomes fully aware of this situation, I think we're going to see a turnaround in this market.

Senator **Bumpers**. Mr. Watson, do you have an explanation as to why wellhead prices are down and prices at the other end either are not or are up? What's happening?

Mr. **Watson**. Well, I think I have an explanation for why some of the wellhead prices are down, but I do not have a very good explanation——

Senator **Bumpers**. I think I understand that end. I'm more curious about the other end.

Mr. **Watson**. The wellhead prices are down because, first of all, about 40 to 50 percent of the gas that we have under production is regulated still as 104 gas under the Natural Gas Policy Act, and it has a ceiling price on it. So it's fairly low.

The other gas, the incentive gas, the newly discovered gas——

Senator **Bumpers**. What's the price of new gas right now?

Mr. **Watson**. New gas is, I think, in the neighborhood of $4, as I recall.

Senator **Bumpers**. You can't get that for it, can you?

Mr. **Watson**. No, sir.

Senator **Ford**. $4.11.

Senator **Bumpers**. $4.11, they say.

Mr. **Watson**. It changes monthly. The ceiling changes monthly in accordance with the provisions of the NGPA. No, you can't get $4.11 for it. If you had a package of gas, you could not get $4.11.

Senator **Nickles**. Well, I was going to say, I think there's a misconception. I want somebody else to clarify what the price of gas is so Senator Bumpers will know what the price of gas is right now in the market. It's not any $4.11.

Mr. **Watson**. I think the average is——

Senator **Nickles**. What's gas selling for today?

Mr. **Pickens**. In mid-1985 it was $2.81.

Senator **Bumpers**. $2.79, I'm told.

Mr. **Watson**. That's probably correct.

Senator **Bumpers**. On the spot market. Is that correct?

Mr. **Nelson**. No, sir; that's average wellhead.

Senator **Bumpers**. I'm sorry?

Mr. **Nelson**. Average wellhead.

Mr. **Hentschel**. The spot market is probably $2.15, $2.20.

Mr. **Watson**. Or maybe even lower in some places.

Senator **Bumpers**. What was the spot market and what was the wellhead—average wellhead price 2 years ago?

Mr. **Nelson**. There was no spot market.

Senator **Bumpers**. What was the average wellhead price 2 years ago?

Mr. **Nelson**. It was probably in the range of——

Mr. **Harrison**. Gulf coast spot prices at the beginning of this year was just under $3, and gulf coast spot prices now are probably just over $2, not much over $2.

Senator **Bumpers**. Well, of course, Mr. Watson, one of the explanations of course is that there are a lot of take-or-pay contracts, aren't there, long-term contracts where the price was locked in a long time ago? I mean, when we talk about the price of gas, we're talking about probably a very—it's a minority share of the gas. Most of the gas is contracted for at prices that were made a long time ago. Is that not correct?

Mr. **Watson**. That's probably true.

Senator **Bumpers**. That would be one of the reasons the price at the end of the pipeline haven't gone down, wouldn't it?

Mr. **Watson**. No, I don't believe so.

Senator **Bumpers**. Well, an awful lot of people are locked into a lot higher price than $2.79, aren't they?

Mr. **Watson**. Some are, but not at the other end of the pipeline. As I understand it—and again, I'm not well versed in interstate pipeline contracts with distribution companies and industrial customers—but as a general rule, those contracts aren't for as long a period of time long term like the historic contracts were between the pipelines and the independent producers. Most contracts historically were 20 years, and over the years have dropped some, but they are historically are long-term contracts, long-term dedications; whereas, the contracts that the interstate pipelines make with the distribution companies and industrial customers generally I don't believe are for that long a period of time.

I'm sure some of the interstate pipeline witnesses will be able to give you a much better answer to that than I can.

Senator **Bumpers**. Well, I'm not going to pursue that, Mr. Chairman. I know you've got a long day ahead of you, so I won't take any more time. Thank you, very much, gentlemen.

Mr. **Watson**. Mr. Chairman, I would like to make one further comment, if I might, to the question that Senator Ford asked some of the gentlemen about take-or-pay and equal access to the pipeline.

The problem that I'm not sure that some people understand is that, whereas the large producers may very well have many contracts over which they could negotiate with a pipeline company for a reduction in take-or-pay, and most of the companies have indicated they would be willing to do that on an individual contract-by-contract basis, but should not be ordered to give up all take-or-pay.

But the small independent producer is in a different situation. He doesn't have a lot of contracts that he can negotiate with that interstate pipeline.

Senator **Ford**. Mr. Watson, that's the reason I asked the left side of the table and not your side.

Mr. **Watson**. Yes, sir. [Laughter.]

Senator **Ford**. And a small independent is awful large.

Senator **Nickles**. I want to thank our panel. I do want to put in the record, when we're talking about spot gas prices, according to Gas Daily, it mentions Texas Gulf was from $1.98 to $2.03. This is dated November 18. Louisiana Gulf was $2.20. North and South, $2.03 and $2.10. West and East Oklahoma is $1.95 in spot prices.

So I thought there was an impression that people were getting $4.10, and I like to came out of my chair.

Mr. **Watson**. Mr. Chairman, I would like to make a comment to Senator Ford.

Senator **Ford**. I only asked two questions and I stirred up the whole panel, Mr. Chairman. [Laughter.]

Mr. **Harrison**. I gave a very brief answer of "no" to his question because that seemed to be what he was looking for. But in any event, it seems to me that that requires a few more comments than just a no answer.

We are very definitely involved in negotiations on these take-or-pay issues. It's not a matter of a closed mind to the pipelines, and it does get into a matter of abrogation of contracts and trying to pass rules that would require an abrogation in that case. We don't think that should be done. There are a lot of issues in those contracts other than take-or-pay.

When you get involved in negotiating a take-or-pay issue, there's a whole range of things. There's a percentage of minimum take-or-pay. There's where do they pick up the gas? There's processing arrangements. There are lots of clauses in those contracts other than just take-or-pay. So why pick on take-or-pay and go in and say we're going to abrogate that contract on a take-or-pay issue. That's unfair to us. We don't think it should be done. It's a contract that's negotiated and agreed upon, and we think the parties should work it out.

Senator **Nickles**. Mr. Harrison, I appreciate your comments. I will tell you that this committee has spent a great deal of time talking about contract abrogation, and I for one am bothered about the abrogation on the buyers' end and we're going to have pipelines testifying in a minute, and I think we'll hear likewise the pipelines are concerned about having their contracts abrogated. Producers, of course, are concerned about having their contracts abrogated.

I'll mention the same thing, and we just touched on it briefly. I have several questions to ask each of the panelists, but in all fairness to our next two panels, I need to move on. So I will be submitting additional questions, but dealing with the old gas DOE's rule.

Mr. Eck, I'll just make the comment that I appreciate your comment in saying that the proposal—I didn't hear this from all of our panelists—but the proposal by DOE was to—and I haven't thoroughly examined it; I saw the brief of it—but as your statement was, I would support it as long as it was within the original contract constraints. I don't think we should go in and abrogate those old contracts. Again, that's the direction of the legislation.

One final question. Senator Murkowski asked if we could get people together, and I'm going to ask this of the other panels as well. We have introduced legislation that would deregulate gas, those remaining categories that are still regulated, as those contracts expire, or as they're renegotiated.

Also, we eliminate end-use restraints, the Fuel Use Act, and incremental pricing. We do not have at this time a contract carriage provision.

Would you all support the language that we have in our bills to date? Is there anybody who would not on the panel?

Mr. HOLLAND. Yes. I think that——

Senator NICKLES. OK. Can I stop you right there? How many, would the panel—we have heard some comments made, Senator Bradley has worked and we've worked, not necessarily—we've tried to come up with a contract carriage provision.

Does this panel support a contract carriage provision in a bill which is not presently in the bill that I envision? Is there anybody who would oppose a contract carriage provision?

Mr. HARRISON. As part of a comprehensive legislation, probably could.

Senator NICKLES. All right. I thank the panel very much for your cooperation. Again, we will have additional questions submitted to you.

[Subsequent to the hearing Mr. Holland submitted the following:]

Mobil Oil Corporation

150 EAST 42ND STREET
NEW YORK, NEW YORK 10017

H.K. HOLLAND, JR.
VICE PRESIDENT PRODUCING
EXPLORATION AND PRODUCING DIVISION

November 25, 1985

Senator Don Nickles
Hart Building
Room 713 H
Washington, D.C. 20510

Dear Senator Nickles:

At the end of the panel discussion before your subcommittee last week you asked each of us whether we supported the natural gas bill S. 1302 which you introduced on June 13, 1985. Time did not permit me to express a concern which Mobil has regarding your bill and I would like to take the opportunity to do so in this letter.

First, I would like to commend you for introducing a far reaching piece of legislation designed to remove the market distortions which have resulted from wellhead price regulation over a period of many years. We urge you to consider a modification to the bill, however, which would make it truly comprehensive decontrol legislation: eliminate price controls on gas being sold under "life of lease" contracts.

Paragraph 5 subsection (f) of Section 101 in S. 1302 addressed life of lease contracts merely by providing for renegotiation of such contracts if they contain a renegotiation provision. Contracts which do not contain such a provision would continue to be subject to existing price controls. We believe the industry, the State of Oklahoma, other producing states and the nation as a whole can best be served and long term supplies of natural gas for the future insured by eliminating all controls from first sales of natural gas without regard to whether contracts contain renegotiation provisions. I enclose a suggested text which could be used to achieve this goal.

I believe, as you do, in the sanctity of contracts. The proposal for lifting price controls from gas sold under life of lease contracts would leave the contract provisions intact. Therefore, if a contract provided for an alternative pricing mechanism in the absence of federally imposed prices, the alternate mechanism would apply. If a contract provides for renegotiation in the event of decontrol, then the parties would proceed to renegotiate, all as provided for in the contract.

I personally was pleased to participate in your hearings on Thursday. I found the views of the panelists and the questions from your colleagues both stimulating and enlightening. My congratulations to you for assembling such a diverse group of industry spokesmen and for the manner in which you conducted the hearings.

Very truly yours,

HKHolland, Jr.

H. K. Holland, Jr.

/jb901

Enclosure

Paragraph (5) of subsection (f) of Section 101 of Bill S-1302 should be modified to read as follows:

"(5) gas subject to any contract for the first sale of natural gas which does not expire by its own terms at the end of a fixed term of years. Any such contract which contains a renegotiation provision, or any such contract which is a successor to a contract which contained a renegotiation provision, shall be deemed eligible for renegotiation pursuant to such provision, and any otherwise applicable limitation of the Natural Gas Act or this act shall not apply".

Senator NICKLES. If our next panel could be seated, we'll begin. I apologize to our last two panels. We have a direct relationship. If we have less Senators, this will move quicker, but I appreciate my colleagues interest.

Senator FORD. That just gives us more time to ask questions, Mr. Chairman.

Senator NICKLES. That's right. [Laughter.]

Our first panelist is Peter King, who is vice chairman of Colorado Interstate Gas Co., representing the Interstate Natural Gas Association of America.

Mr. King, welcome. You have to really pull that microphone very close, I think. Thank you.

STATEMENT OF PETER J. KING, JR., VICE CHAIRMAN, COLORADO INTERSTATE GAS CO., REPRESENTING THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA, COLORADO SPRINGS, CO

Mr. KING. Thank you, Mr. Chairman, and members of the subcommittee:

I am Peter J. King, Jr., immediate past chairman of the Interstate Natural Gas Association of America, the trade association for major interstate natural gas pipelines, and vice chairman of Colorado Interstate Gas Co.

Our written comments filed with the committee go into some detail on the equities and problems we perceive in Order 436. I would like to cast my remarks to the committee in a somewhat broader vein, if I may.

Senator NICKLES. Certainly.

Mr. KING. Order 436 is a new, untested regulatory scheme. Its consequences may prove severely detrimental to the natural gas consumers. Competition has a part to play in the pipeline industry. More open access has evolved in material proportions in recent years and continues to increase. But the natural gas industry has unique characteristics which Order 436 doesn't recognize and may destroy.

Natural gas consumers, householders, small- and medium-sized commercial and industrial users, and local distribution companies have no choice. They're committed to and dependent upon an energy source which, by its nature, must assure stability both of price and supply on a long-term basis if it is to serve its purpose.

Imperfect as it may be, the pipeline industry has been the balance wheel between supply and demand, between producers and consumers, to ensure that long-term stability. What happens when that role disappears, to be replaced by the common carriage of Order 436?

Assuming a gas surplus continues for many years—an assumption central to Order 436—the consequences still will be severe. You will hear, I am sure, from my colleagues on this panel as to the effects on pipeline companies. In addition, costs will shift between consumers.

Large-local distribution companies and large industrial customers may benefit. Smaller local distribution companies and other smaller customers without the resources to bargain independently for gas supply will suffer as additional costs are shifted to their shoulders. Pipeline control supply will dwindle. Except for partial fixed cost recovery, the Federal Energy Regulatory Commission has outlawed minimum bill and minimum take provisions in pipeline tariffs.

Consequently, with uncertain markets and contractual restrictions, pipelines will be at a competitive disadvantage with local distribution companies and industrials who are free to make any agreements they wish with third-party suppliers. The pipeline is reduced to a supplier of last resort with uncertain and volatile markets.

To expand on that, Mr. Chairman, it is not well understood that the order would allow a pipeline's customer to purchase third-party gas on the spot market, and take advantage of interruptible transportation service to displace pipeline gas without losing any contractual right to swing back to pipeline supply whenever it desires.

As I have stated, this relegates the pipeline to the role of backup supplier. Yet, not only would the pipeline have no relief from the purchase obligations to producers, but it would be obligated to maintain its reserves to serve its customers, even if the customers choose not to buy from that supply.

Furthermore, the producer could resell the gas not taken by the pipeline while the pipeline would still be obligated to make take-or-pay prepayments. The pipeline thus gets stuck both ways. On top of this, the order grants pipeline customers unilateral right to reduce their existing contract purchase levels by 25 percent per year.

Consequently, in short order pipelines no longer will be able to provide long-term assurances of peak day and annual supply to their customers. However, the prospect is that today's gas surplus will be replaced by a shortage in the near future.

What happens then? A shortage will not be remedied overnight. I believe probably about a 5-year lag in correcting it will occur. A weakened pipeline industry, its gas supply impaired, will be unable to fill the gap. A Darwinian struggle may ensue for the gas available with volatile price increases and shortages for domestic and commercial users.

There is much more at stake in Order 436 than pipeline interests. There are public policy interests of a very material nature affecting every natural gas consumer in this country.

Thank you, sir.

[The prepared statement of Mr. King follows:]

STATEMENT OF
PETER J. KING, JR.
ON BEHALF OF THE
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
NOVEMBER 21, 1985

Mr. Chairman and members of the Subcommittee:

I am Peter J. King, Jr., immediate past Chairman of the Interstate Natural Gas Association of America (INGAA) and Vice Chairman of Colorado Interstate Gas Company. I appreciate the opportunity to appear before you today on behalf of INGAA to discuss the Federal Energy Regulatory Commission's (Commission's) Order No. 436 of October 9, 1985, and its Notice Requesting Supplemental Comments on the block billing proposal.

INGAA is a non-profit national trade association representing virtually all of the major interstate natural gas transmission companies operating in the United States. Our member companies are both wholesalers and transporters of natural gas who move gas from the producing areas to distributors and end users across the nation. Approximately 90 percent of the natural gas transported and sold in interstate commerce flows through more than 200,000 miles of pipeline owned and operated by INGAA member companies.

Introduction

In promulgating its final rule in Docket No. RM85-1-000 on October 9, 1985, the Commission placed into effect Parts A and C of its Notice of Proposed Rulemaking (NOPR) of May 30, 1985. Part A is a nondiscriminatory, open access, blanket transportation program. Part C is an optional expedited certificate procedure for the construction and operation of new sales or transportation facilities and for the provision of new services. The Commission chose not to adopt Part B of the NOPR, instead reaffirming its

April 10, 1985 policy for dealing with the recovery of prepayments made to settle take-or-pay liabilities and implemented an expedited abandonment procedure for producers with shut-in gas. Finally, the Commission requested supplemental comments on Part D, the block billing proposal.

Today I will discuss the major shortcomings of the Commission's final rule and explain why INGAA believes that a legislative alternative to the Commission's rulemaking is necessary.

There has been criticism of interstate pipelines since November 1, because relatively few have decided to participate in the Commission's "voluntary" program, but in fact the open access transportation program offered by Order 436 is weighted against the interstate pipelines. INGAA cannot speak to any individual company's decision to participate or not participate. Some of the companies participating in the transitional phase may choose to drop out December 15, when that phase ends, and others may decide to sign up. We do not know.

INGAA participated fully in the Commission's rulemaking proceedings. We filed extensive comments and made numerous recommendations for modifying the proposed rule. Our objective was to help the Commission fashion a rule that would continue important transportation programs, and balance fairly the interests of consumers, distributors, producers, and transporters of natural gas. However, the Commission's Order 436 falls far short of this objective. The Commission failed to adopt those recommendations that would have made for a more "even handed" rule.

Given its controversial nature, it is inevitable that many aspects of the Order will be subject to court challenge. Not only will such litigation be lengthy, but it will likely result in overturning some or all aspects of the Order. Indeed, INGAA believes that the Commission's actions in Order 436 exceeded its statutory authority in several key respects. For these and other reasons INGAA has concluded that legislation is necessary. In my statement, I will focus on some of the more notable adverse features of the Order.

The Take-Or-Pay Problem

In issuing the Notice of Proposed Rulemaking, the Commission recognized that take-or-pay problems pose a threat to the industry and proposed a method for addressing these disputes which the Commission hoped would encourage pipelines and producers to negotiate. INGAA, among many other commenters, argued that the mechanism proposed by the Commission was unworkable and, indeed, the Commission withdrew the proposal, choosing to reaffirm its existing policy relative to take-or-pay -- a decision, in effect, to do nothing substantive by way of ameliorating the serious take-or-pay problems confronting interstate pipelines.

Yet, as recently as June 24 the Commission itself recognized that the success of the rulemaking is dependent upon successful resolution of the industry's take-or-pay problems. In its filing of that date with the D.C. Circuit Court of Appeals in the Maryland Peoples' Counsel case, the Commission stated "(T)ake-or-pay is an overarching impediment in the movement toward a more competitive market, and more specifically to broader pipeline transportation programs." Yet despite this realization, the Commission has not included within the final rule any mechanism for dealing with this "overarching impediment."

There is a perception that take-or-pay is no longer a real problem for the industry. Nothing could be further from the truth. First, it must be remembered that most settlements to date involve past, not future, obligations. Our data show that at the end of 1984 take-or-pay exposure was $5 billion, with another $3 billion estimated for 1985. If Order 436 remains unchanged, we estimate the exposure to escalate significantly beyond the $8 billion amount. This is so because not only does the Order contain no mechanism to encourage contract renegotiation, but in at least two ways it will actually exacerbate the problem. Furthermore, the Order effectively destroys the very tools that have enabled pipelines to achieve the limited success they have had to date in contract renegotiation.

First, the Order will worsen the take-or-pay situation in that a pipeline customer may initiate unilateral reductions in its contract demand up to 25 percent a year. As the customer reduces its purchases of gas from the pipeline's system supply, the pipeline will be unable to meet its purchase obligations to its producers and thus will face greatly increased take-or-pay exposure. Without some form of relief, the pipeline will confront an unexpected drain on its revenues and the pipeline's so-called captive customers will be confronted with an increased share of total take-or-pay costs.

Secondly, contrary to what some have suggested, this problem would not be cured even if the FERC drops the contract reduction option. The take-or-pay problem would remain, because of the requirement that participating pipelines provide interruptible transportation service along with firm service. This gives the customer of a participating pipeline the right to displace a pipeline's gas with interruptible spot market supplies, without reducing the pipeline's firm sales service obligation. Thus, the rule places the pipeline in the untenable position of being obligated to provide service at full contract levels at all times even though its customer may be substituting spot-market gas for pipeline gas most of the year. Obviously this could lead to intolerable take-or-pay problems. Further, a pipeline in this circumstance would be expected to maintain the reserves necessary to meet the contract demand obligation. No pipeline can retain a gas supply sufficient to insure reliable, uninter- rupted service for the long term under these conditions.

To illustrate my point, take this simplified example of a hypothetical pipeline customer who is entitled to take 100 units from a pipeline. Assume the pipeline has a contract with a producer to provide 100 units of gas supply with an 80 percent take-or-pay level. Under the rule, a pipeline's customer could retain its full contract entitlement, but substitute 100 units of spot market supply delivered on an interruptible basis, for the gas supplied by the pipeline. The customer has no incentive to reduce its contract entitlement from the pipeline because:

-- the customer is no longer under an obligation to purchase a minimum amount of gas, because the Commission has already removed commodity cost from pipelines' minimum bills in Order 380;

-- if the customer's spot market supply fails in total or in part, or if the price goes up, the customer could simply swing back to the pipeline, which would still be obligated to provide up to 100 units of firm sales service to the customer; and

-- the customer would incur little, if any, risk of having its transportation service interrupted for capacity reasons. Because the customer has not reduced its contract demand, the pipeline cannot abandon sales service and cannot commit the customer's capacity to other new buyers; thus the capacity would be left for the customer's interruptible service.

As this example shows, a customer is likely to adopt such a strategy because it could thereby minimize its purchased gas costs with little concern for losing its capacity or firm sales service, and without paying any premiums for the insurance. The pipeline, on the other hand, would be faced with 80 units of take-or-pay liability in order to keep sufficient supply available to meet contract commitments to the customer.

While Order 436 worsens a participating pipeline's take-or-pay exposure, it also destroys the tools that the industry has used to date to encourage renegotiation with producers. Up to this time, a pipeline has been able to offer producers increased takes of gas in exchange for reduced purchase obligations. Frequently these increased takes went into a pool of SMP gas or the pipeline would otherwise move the gas.

However, Order 436 gives the producer unconditional access to the pipeline's system. Thus the pipeline seeking take-or-pay relief can offer the producer virtually nothing that he does not already have.

The producer benefits in this situation because as the pipeline's take-or-pay obligations continue to build up, the producer can utilize the pipeline's facilities to sell his gas elsewhere. The pipeline gets stuck both ways.

INGAA believes that the Commission could and should have dealt with the problem of take-or-pay within the context of Order 436, by conditioning producer access to interstate pipelines under the new transportation program on adequate take-or-pay relief. If the rule had provided that a producer could only gain access to open transportation after voluntarily renegotiating its high-take, high-cost contracts, there would have been a strong incentive for renegotiating the very contracts that now inhibit the transmission of market signals to the wellhead. But the Commission has refused to use this power to condition producer access to transportation on negotiated contract relief, on the theory that it does not have authority to so condition producer access. The Commission had no such doubts when it came to restructuring the relationship between pipelines and distributors.

Thus, a pipeline choosing to participate in the transportation program created by Order 436 is confronted with increased take-or-pay exposure, reduced sales, increased difficulty in maintaining supply to meet firm sales obligations and increased operational problems associated with being a backup or peaking supplier. A pipeline choosing not to participate, on the other hand, is confronted with lost sales and transportation service to competitors, increased fixed costs to remaining customers, prolonged traditional Section 7 certificate proceedings for providing transportation service and rate case penalties for failure to participate.

Either way, Mr. Chairman, Order 436 is weighted against the pipelines with few benefits accruing either to them or their customers.

Other Concerns

While my statement has focused on the take-or-pay problems associated with the Order, there are other serious shortcomings:

1. The pipeline must make a FERC rate filing following a distribu-

tion customer purchase obligation reduction, no matter how small it may be or how recent its last filing. This is an onerous, time-consuming and expensive undertaking, which may be far out of proportion to the amount involved.

2. Purchase obligation reductions involve the shifting of costs from customer to customer, if the pipeline is to remain whole. In many cases these costs will ultimately fall on smaller full requirements customers who are and will remain totally dependent on their pipeline supplier. As noted above, the reliability of their future supply is threatened, also.

3. The transportation provisions are a one-way street. They offer the pipeline company no meaningful incentives to becoming an open transporter, and substantial potential for harm:

   a. The FERC's preamble to the Order intimates that projected transportation volumes will be set so high as to make their attainment unlikely. Commission practice insures that pipelines will be put at considerable risk to meet inflated transportation volume projections. In the unlikely event that the projections are met or exceeded, subsequent upward volume adjustment will wipe out any benefits of so doing.

   b. No economic assurances are required from shippers (other than a "Capacity Reservation Charge" for firm transportation) that they will in fact utilize nominated pipeline capacity. The entire risk of under-utilization falls on the pipeline.

   c. Required pricing of interruptible transportation gas provides no financial incentive.

   d. Pipelines electing optional expedited certification of facilities are put at risk forever if volumes do not meet projections. However, as noted above, if volumes exceed those estimated, future adjustments can eliminate any benefits to the pipeline.

In addition to the concerns I have already mentioned, the rule is ambiguous and contradictory on several key points. In fact, the Commission has issued and continues to issue numerous clarifications and corrections. Additional requests for clarification are still pending before the Commission. Although the Commission Staff has been cooperative in addressing our questions, answers are sometimes contradictory or provide an understanding of Commission intent not even mentioned in the final rule.

Also bear in mind that pipelines were faced November 1 with a very critical decision. Each pipeline responded to the final rule based upon its own individual corporate judgment as to the impact of the program on the unique characteristics of its system and the customers it serves -- sales as well as transportation customers.

The Commission acknowledged the increased risk in its NOPR and implied that risk would be considered in setting rates. Order 436, however, is silent on this point. A pipeline would be negligent in its responsibilities to its shareholders, bankers, employees, and, most of all, its customers if it did not adequately assess the risks in making its business decisions.

Block Billing

INGAA in its comments on the block billing rulemaking filed with the Commission on November 18 emphasized the need to provide interstate pipelines with the flexibility necessary for them to compete with other buyers and sellers of natural gas in the market. This would entail providing the means for affirmative relief from non-market responsive contracts. The Commission's current proposal does not do this.

Legislative Alternative

INGAA is seeking a legislative alternative to the Order not only because it is biased against interstate pipelines, but also because we believe much that the Commission has proposed is unlawful and unjustified based on the record. Already the rule has disrupted gas supplies in certain aspects of the marketplace. It has created confusion and instability, which we believe can only be resolved through legislation. We are seeking a straightforward legislative amendment to existing natural gas law which will:

1. provide open nondiscriminatory access to transportation in a manner fairly balancing the interests of consumers, distributors, producers and transporters of natural gas,

2. assure consumers of reliable and adequate supplies of natural gas at market responsive prices, and

3. equitably resolve gas supply contracts which are not responsive to market conditions.

Summary

Mr. Chairman, transportation on behalf of non-pipeline shippers, distributors and end users has been an important and growing segment of the interstate natural gas business. For the second quarter of 1985, transportation for others increased by more than 50 percent (compared to 1984), and carriage for distributors and ends users accounts for 16 percent of the natural gas consumed in interstate markets in the second quarter. In spite of our progress in increasingly opening our systems for transportation for others, criticism persists that the pipelines have been reluctant to participate in the Commission's new "voluntary" program, because they do not want to transport gas. INGAA submits that the facts prove otherwise.

The Commission's rule relieves the customer of its obligations but does nothing to provide relief for the pipeline from its firm sales or purchase obligations. Furthermore, the Commission has promulgated an Order that is fraught with legal difficulties. This is so at least in part because the Commission, while responding to the widespread desire for a transportation program, is restructuring the natural gas industry in a way that is really inconsistent with the underlying statutes which the Commission is charged with implementing. We look to Congress to balance the public interest more fairly on on these important issues.

This concludes my statement, Mr. Chairman. I will be pleased to respond to any questions the Committee may have.

Senator NICKLES. Mr. King, thank you very much for your comments.

Our next panelist we have is Brian O'Neill, president and CEO of Transcontinental Gas Pipeline from Houston.

STATEMENT OF BRIAN E. O'NEILL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, TRANSCONTINENTAL GAS PIPELINE CORP., HOUSTON, TX

Mr. O'NEILL. Thank you very much, Mr. Chairman.

Let me say at the outset that Transco has consistently advocated total and complete deregulation of natural gas supplies. It's our view that gas prices should be set by the marketplace. It's more efficient. It's much more likely to achieve a viable supply/demand balance, and it would induce a much healthier competitive situation.

The current abysmal state of the industry, in our view, is in large part directly attributable to the fact of regulation of gas pricing. The numerous tiers of gas prices which have evolved have spawned a whole host of special interest groups adverse to the free operation of the marketplace, because it would eliminate the competitive advantages bestowed by regulation.

The basic concept of Order 436—that is, permitting free and open access to the capacity of interstate pipelines—is a concept we enthusiastically support. Transco perceives its proper role in the industry to be that of a transporter and, frankly, has no interest whatsoever in continuing to perform the merchant function of buying and selling gas.

Pipelines, being regulated utilities, earn on their investment and thus, by transporting gas, not by buying and selling it. Of course we recognize that this merchant function has traditionally been performed by the pipeline, and Transco has been no exception. Our contracts with both our customers and our producers have been structured in a way to reflect this role.

I would emphasize here that our contracts to sell to both the distributors and to purchase from the producers are, and traditionally have been, long-term contracts. Gas purchased on this basis has been rolled in and sold to our customers on an average-cost basis. Order 436 seeks to totally restructure this traditional way of buying and selling gas.

Now the unfortunate paradox created by Order 436 is the fact that it espouses free and open access to our Nation's pipeline systems by customers and producers alike, and presumably encourages development of a free and competitive marketplace for gas; but, at the same time, wholly fails to take the steps necessary to rationally reorder the existing structure in an evenhanded and workable fashion.

To be sure, more than adequate steps have been taken to reorder the customer pipeline side of the equation. Minimum bills have been emasculated, and methods for distributors to reduce their contract obligations are provided for in the order. No corresponding steps have been instituted, however, to reflect this change on the producers 'side of the equation. In fact, the Commission appears to be almost paranoid in its reluctance to address a most critical element of the equation; namely, the contracts between the pipelines and their producers.

If in fact it's determined to be beneficial to change the traditional structure to permit the marketplace to function, and we enthusastically support such a view, then a proper allocation of the burdens of such a change has to be implemented in some reasonable manner. This sharing of the cost burdens necessarily requires that above-market price contracts and potential take-or-pay problems both be addressed.

The Commission, however, has not done this. What it has done is to declare open access, insulate the customers and producers from any adverse impact, and then pretend there's no problem. That is, by suggesting that take-or-pay problems of pipelines have been overstated and letting the pipeline shareholders absorb the full cost impacts of the restructuring. In fact, because customers would be willing to substitute—or, excuse me, would be able to substitute interruptible spot gas for regulator supplies they would otherwise have taken, the potential cost impact to the pipeline is dramatically inflated.

Even if it were fair to foist the entire inflated cost burden on the pipelines—and we don't think it is—the problem remains that it simply does not have the resources to absorb such potential costs, and consequently have decided there's no way we can reasonably agree to the open access provisions of the order because the result potentially would be disastrous.

If Transco were to accept the open access provisions of the order as currently in effect, it has every reason to believe that its customers would immediately displace all of its regular systems supplies with cheaper, interruptible spot gas. In fact, there would be every economic incentive for the customers to do so.

This action, in turn, would have two immediate devastating impacts.

First, we would have no way of taking the approximately 850 million cubic feet per day of casinghead drainage and well protection gas we're obligated to take. And, incidentally, we've barely been able to take this amount of gas recently even without accepting open access.

Second, we would incur tremendous additional potential take-or-pay liabilities, which we estimate on our system alone could exceed $5 billion just in 1986 and 1987. Notice particularly that although the customers can replace all of our system gas with spot supplies, nothing has been done to diminish the pipeline's obligation to have a firm gas supply available for its customers if, as, and when they may call on it.

The Commission has thus far failed in its efforts to resolve the problems caused by its order because of its adamant refusal to deal with the take-or-pay problem. The result inevitably will be endless litigation and uncertainty. Consequently, we are of the view that a legislative solution is the way to go.

Thank you very much.

[The prepared statement of Mr. O'Neill follows:]

Written Statement of

BRIAN E. O'NEILL

President and Chief Operating Officer
Transcontinental Gas Pipe Line Corporation
A Subsidiary of Transco Energy Company

My name is Brian E. O'Neill. I am president of Transcontinental Gas Pipe Line Corporation (Transco), a wholly owned subsidiary of Transco Energy Company.

As to my personal background, I am a graduate of the U.S. Naval Academy and the University of Texas School of Law. I practiced with the firm of Andrews, Kurth, Campbell & Jones from 1965 until 1975 and was a partner in that firm at the time I joined Transco as vice-president, general counsel and secretary. I became president of the pipeline company in May of 1982.

I wish to thank the Subcommittee for permitting me to present Transco's views on the Federal Energy Regulatory Commission's Order No. 436 entitled "Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol", issued on October 9, 1985 in Docket No. RM85-1 (the "Final Rule"). Transco has, for a considerable period of time, supported the concept of free and open access to our nation's gas pipeline system - a concept which is espoused in the Final Rule. Unfortunately, as I shall presently describe, Transco believes that the Final Rule fails woefully to effectively achieve this purpose because it is deficient in many respects, primary of which is its failure to address in any meaningful way take-or-pay and above-market priced contracts, the most significant and pervasive problems facing the natural gas industry.

The principal business of Transco is the sale, transmission and storage of natural gas. Transco's mainline interstate gas transmission system extends from the Texas and Louisiana Gulf Coast area to New York City. Transco's principal market encompasses eleven southeast and Atlantic Seaboard states, including the Philadelphia/New York metropolitan area. The majority of the gas Transco delivers originates from areas located onshore and offshore in the Gulf Coast areas of Texas, Louisiana and Mississippi. The gas delivered by Transco is composed of gas purchased by Transco for resale to its customers and gas transported by Transco for others.

As this Subcommittee is well aware, interstate pipelines have traditionally sold gas to customers under long-term contracts. To meet the needs of such customers, pipelines purchased gas from producers under long-term contracts. To obtain the certificate required to construct pipeline facilities, the company proposing to build a pipeline was required to demonstrate that it had long-term contracts for the sale of gas to gas distributors with established market requirements at one end of the proposed pipeline and a long-term supply of gas at the other end. With respect to the long-term contracts with producers, such contracts typically contain take-or-pay provisions requiring the pipeline, under certain circumstances, to take gas or nevertheless pay for gas not taken. These take-or-pay provisions have evolved, due to a variety of factors, from obligations based on a percentage of original recoverable reserves to obligations based on deliverability. With cash flow directly tied to a percentage of deliverability, producers have been encouraged to develop the highest deliverability possible from given reserves.

Since approximately 1982, there has been a nationwide excess of currently deliverable natural gas. That excess, coupled with reduced demand arising from decreases in the prices of alternate fuels, milder than normal weather and increased conservation, have resulted in decreasing prices for natural gas and increased competition for markets. One of the first to respond to these changing conditions, Transco aggressively altered the manner in which it traditionally conducted its business by utilizing its available pipeline capacity to transport for its customers substantial gas supplies that such customers have purchased on a spot market basis directly from other suppliers of natural gas. Transco estimates that approximately one-half of the gas delivered by it during 1985 will consist of gas transported for others as compared to 32% during 1983.

In Transco's view, the competitive environment dictates that it is no longer appropriate for it to perform the merchant function of buying and reselling gas and that its proper function is to engage in transportation, storage and related services. Gas sales should be made by non-jurisdictional entities who can provide far more flexible purchase arrangements to customers.

At the outset, and lest my remarks be misinterpreted, I would like to state that Transco commends the Commission for its effort to address the current problems in the natural gas industry. Transco recognizes that the existing regulatory framework is not sufficient to deal with the rapidly evolving changes in the industry's traditional methods of doing business. However, Transco believes that if an effective solution to the problems facing the natural gas industry is to be achieved, actions must be taken to address all aspects of such problems, not just the contracts between pipelines and customers but also the contract problems between pipelines and producers. The move toward a less regulated, more market-oriented industry must be accomplished by measures that restructure the relationships between local distribution companies, pipelines and producers. In Transco's opinion, the Final Rule is fundamentally flawed in that it does not implement a comprehensive restructuring of the industry. In view of the shortcomings of the Final Rule and the tremendous potential liabilities which it not only fails to address, but in fact would exacerbate, Transco has determined that it cannot responsibly elect at this time to provide "open access" transportation.

* * *

The Final Rule was issued by the Commission on October 9, 1985 as an outgrowth of the Notice of Proposed Rulemaking (NOPR) on the subject of Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol. The NOPR appears to have been based upon a recognition by the Commission of the following facts:

(1) Pipelines have been generally unable to renegotiate their high-priced, high take-or-pay gas purchase contracts except on a temporary stop-gap basis.

(2) There is a surplus of deliverable supplies committed to many pipeline systems which has not only created take-or-pay problems for those pipelines but has precluded any significant outlets for new gas supplies currently being found by producers.

(3) The surplus of existing commitments to pipelines -- and the concomitant inability of producers to market through traditional channels to pipelines -- has caused uncommitted gas to be offered on better terms and at lower prices than those provided under the high-priced "problem" contracts entered into by pipelines in the 1970's, some of which are still regulated under the NGPA at maximum lawful prices considerably above market clearing levels.

(4) There has been a widespread clamor by practically everyone, except the beleaguered pipelines, for greater access to the cheap new gas supplies which are available at low prices because of the temporary glut of supply. Since pipelines have been traditionally required to price their sales on the basis of rolled-in gas purchases, not only would acquisition by pipelines of new, cheaper supplies exacerbate the existing surplus and take-or-pay problems, its impact on average gas costs would be substantially diluted. Thus, the clamor has become one for greater access to transportation. Somewhat understandably, end-users, distributors, state commissions, and elected representatives in Congress have placed enormous pressures on pipelines and the Commission to open up transportation and somehow find a way to bring currently committed supplies in line with current market realities. Less understandably, some members of the producing segment of the industry have joined forces with the consumer interests in exerting pressures on pipelines for "open" transportation while at the same time some are refusing to deal reasonably with the high priced, high take-or-pay contracts even on an interim basis, much less a permanent basis.

Faced with the foregoing circumstances, the Commission proposed a comprehensive restructuring of the industry in a package of proposals contained in the NOPR.

In its comments to the NOPR (copy attached as Exhibit A), Transco agreed with the Commission's perception of the problems in the natural gas industry, the general objectives of the Commission in bringing gas prices under long-term contracts into line with market realities and making gas which is currently surplus available to consumers at low market oriented prices by means of increased transportation by pipelines. Although it did not endorse the concept of block billing, Transco does believe that a "levelling of the playing field" is essential to proper operation of a free market and suggested ways to implement such a concept without subjecting pipelines to the inevitable avalanche of take-or-pay claims by producers whose gas would be shut-in as unmarketable under a block billing mechanism. Additionally, Transco made constructive but necessary suggestions as to how open access transportation could be implemented without creating suicidal conditions for pipelines whose gas sales would be displaced.

Although it cannot be said that the suggestions of Transco were ignored by the Commission, it can safely be said that the principal suggestions were rejected in such a way as to almost deliberately place pipelines in jeopardy of future survival. The Final Rule as adopted, as well as the block billing proposal as renoticed, if adopted, would expose pipelines to massive contract take-or-pay and damage claims by producers, whether the so-called "voluntary" open access provision is accepted or not. Moreover, the reasons given for rejecting the major suggestions of the pipelines are wholly inconsistent with reasons given for adoption of other portions of the Final Rule, and the Final Rule -- together with the renotice of the block billing proposal -- reflects generally a bias against pipelines and a total lack of understanding of take-or-pay.

1. The Commission's Refusal to Grant Take-or-Pay Relief

Perhaps the most egregious example of anti-pipeline bias in the Final Rule itself revolves around the Commission's refusal to grant take-or-pay relief under existing gas purchase contracts in return for granting to producers the right to sell directly to distributors and end-users and have transported by pipelines gas which producers cannot presently market in traditional channels. The final nail in the pipelines' coffin is inserted with the Commission's wholly unsupported "finding" that it would be unduly discriminatory for a pipeline to refuse to transport for a shipper in competition with its own sales.

First, I would like to discuss the predicament in which the Commission's open access provision places the pipeline industry if such "voluntary" option is accepted. Existing distributors may use any variety of options under the Final Rule. They may choose to maintain their current contracts with pipelines, using those contracts as stand-by, and play the spot gas market for all of their supplies so long as spot gas quantities are available and the prices for such gas stay below the pipeline's commodity cost. The distributors may also choose to exercise their contract conversion or reduction options and locate firm supplies from producers at total prices less than the price that would be paid to the pipeline. Or, of course, the distributors may do some of each. In any event, the result is the same. The producers and the distributors have the best of all worlds, while the pipeline is left with even greater surpluses of gas for system supply than exist today and the exposure to huge take-or-pay and other damage lawsuits by producers.

Given the foregoing inevitable result of massive take-or-pay claims (which the Commission was fully apprised of in the comments filed on the NOPR), what are the Commission's stated reasons for refusing to grant take-or-pay relief as a condition for allowing producers to get rid of their unmarketable gas by displacing with transportation arrangements firm sales commitments of those same producers? First, the Commission says that there is a "serious question as to whether the Commission has the authority to require a non-jurisdictional party to give up a valid contractual right as a condition to obtaining service". However, Transco and a number of other parties, including the pipeline trade association Interstate Natural Gas Association of America (INGAA), believe that the Commission has ample authority through its conditioning power under Section 7 of the NGA to compel producers to grant take-or-pay relief under existing contracts if they wish to displace the sales that would otherwise be made to pipelines under those contracts.

The second reason given by the Commission for refusing to condition producer access appears to be that take-or-pay is really not a serious problem. The Commission notes that despite the estimate of some $7 to $10 billion of outstanding potential take-or-pay liability, actual prepayments reflected in pipelines' rate base have been significantly lower. What the Commission fails to realize, or at least note, is that pipelines probably couldn't even fund $7 to $10 billion of prepayment liability and that this situation has led simply to outright refusals to make such payments, which in turn has spawned numerous lawsuits by producers presently pending in the courts. While it is difficult to quantify accurately the potential exposure facing Transco were it to provide "open access" transportation and the block billing implemented, Transco estimates that its take-or-pay exposure alone, not considering other potential contract claims, could be in the range of $6 billion for 1986 and 1987.

In addition, the Commission states that pipelines have "bought out" over $470 million of liability for about $80 million (or some 16 cents on the dollar) and that negotiations are continuing. The implication seems to be that pipelines have been able to work out of take-or-pay problems in the past and there is no reason to believe that they will not be able to do so in the future. While it is true that some past take-or-pay problems have been resolved through negotiation, it is also true all such negotiations have not been successful. And of course negotiations are continuing because pipelines have no alternative other than being sued. But the most important points are that (1) Transco knows of no widespread industry use of buyouts such as were envisaged by the "safe harbor" proposal that was discarded in the Final Rule or the Policy Statement of April 10, 1985 which has been resurrected and glorified in the Final Rule, and (2) the take-or-pay problems which have existed in the past when pipelines have generally been refusing to compete with their own sales are but a "drop in the bucket" to the take-or-pay problems which would ensue under the Commission's "open access" rule where pipelines are subject to the potential loss of virtually all their sales without any relief under existing producer contracts.

Finally, the Commission refuses to grant a take-or-pay condition because it wants to provide open access on a non-discriminatory basis to all producers as well as distributors and end-users. What the Commission apparently refuses to recognize is the idea that granting open access at the distributor end of the pipeline -- which permits the distributors to abrogate their contracts with pipelines -- is totally inconsistent with precluding pipelines from a concomitant modification of their contracts with their producers when they grant "open access" to all producers without receiving take-or-pay relief or contract cancellation.

The stark reality is that the system into which the Commission is attempting to force the pipelines would allow distributors and end-users to obtain their supplies at market-oriented prices while permitting the producers not only to sell those supplies which are presently unmarketable because of the gas bubble and to "sell" to pipelines, through attempted enforcement of take-or-pay clauses, the gas which is presently committed under long-term contracts to pipelines to serve existing long-term commitments to their customers, but which will be replaced by the new direct sales by producers. The consumer thus wins by obtaining gas at the market-oriented prices which he would be paying, but the big winner is the producer who gets to enforce his existing non-market oriented gas contracts and at the same time to sell his unmarketable surplus gas. The loser is the pipeline, who is told by the Commission that his contracts with his producers are sacrosanct but his certificated contracts with his distributors aren't worth the paper they are written on. It is difficult to conceive of a rule which could treat the pipeline industry in a more inequitable, arbitrary and capricious manner.

2. The Distributor's Option to Reduce or Convert Firm Contracts

As I mentioned at the beginning of my testimony, Transco desires ultimately to shed its function as a gas merchant and become totally a transporter of gas. In this way the merchant function, which is ultimately to be totally deregulated, can be separated from the transmission and distribution functions which will continue to be regulated at the federal and state levels, respectively. Transco opposes, however, the blunderbuss approach of the Commission which would permit customers to reduce or convert firm contracts by as much as 25 percent per year for four years. This option on the part of the customers, which the Commission in all apparent seriousness terms "voluntary" on the part of the pipeline because it is "accepting" an open transportation program is unsupported by any factual basis. The Commission has made no effort to determine the extent to which distributors may wish to exercise such an option, the rate consequences to the pipeline or the pipeline's remaining customers of any such exercise, the resulting impact upon reliability of supply to captive customers, or where the gas is coming from to fulfill the option. I reiterate that Transco supports a properly supported contract conversion/ reduction mechanism; however, the contract conversion/reduction option as it has been adopted in the Final Rule is arbitrary, capricious and without factual support.

3. Failure to Consider Block Billing

The Commission consistently proclaimed that its NOPR was an entire package which would be considered and adopted simultaneously. Transco took the

Commission at its word in commenting on the NOPR and, when it appeared that pressure was being brought by the producing industry and certain industrial end-users to drop block billing from the package, filed a supplemental pleading in which it specifically endorsed the consideration of the package as a whole. Indeed, the Commission had consistently agreed that all parts of the NOPR should be considered together. Transco did not favor block billing in its comments or, for that matter, any open transportation program which would require it to compete with its own sales and permit its producers and distributors to evade their traditional responsibilities to sell and buy gas, respectively, under the long-term contracts which had been entered into for that purpose. Transco did, however, assume that block billing would be adopted and consequently made constructive suggestions which would permit all parts of the Final Rule to operate without crippling any segment of the industry.

Now it appears that block billing is in serious jeopardy of not being adopted or if it is adopted as now proposed, the Commission has gone out of its way, apparently deliberately, to expose the pipelines to liability under contracts covering gas which cannot be marketed because block billing has been mandated. Either way, the Commission is attempting to place pipelines in the worst of all possible worlds. With continued rolled-in pricing, there are hardly any pipelines which could compete with the spot market prices presently available, which means -- for distributors served by those pipelines which accept open access transportation -- a wholesale shift from purchasing gas from the pipeline to purchasing gas on the spot market from producers. With block billing, the pipeline can still not compete with spot prices unless he "voluntarily" purchases his gas on a sequential market responsive basis regardless of gas purchase contract terms. In either event, the pipeline is deliberately exposed by the Commission to massive contract claims.

4. The Commission's "Solution" on Take-or-Pay

Transco supports the Commission's decision to forego the promulgation of that portion of the NOPR regarding take-or-pay buyouts. The buyout procedure was unworkable and would not have accomplished the Commission's stated goals. Instead, however, the Commission intends to rely on its April 10, 1985 Statement of Policy. Transco believes that the Statement of Policy suffers essentially the same infirmities as the proposal in the NOPR but in some respects (i.e., the absence of any presumption of prudence) is even a step backwards; accordingly, it is a wholly unsatisfactory response to the take-or-pay problems faced by the industry.

Although Transco has been successful in negotiating significant past take-or-pay relief, substantial exposure to take-or-pay claims remains, both for past periods as well as future periods during which Transco believes it will be unable to purchase all of the gas tendered to it by producers even in the absence of the open access transportation provision. If pipelines opt for the latter, the problem is seriously aggravated and extended. The pipeline's markets are thereby subject to further erosion and take-or-pay claims mount exponentially.

The Commission recognized that "virtually all commentators agree that take-or-pay obligations remain a problem for the industry" and that the "safe harbor" proposal was not a means of resolving that problem. Transco does not believe that the existing Statement of Policy is any better as a solution. While it does permit one-time payments in exchange for waiver or amendment of take-or-pay provisions, the fundamental problem remains of the likely inability to raise the enormous funds which would be required to make such one-time payments, and the adverse effect on the pipeline's cost of service. The magnitude of Transco's potential take-or-pay exposure is such that it is unrealistic to expect that Transco could amass the amounts necessary to buy out a substantial portion of the take-or-pay provisions in its contracts in any manner which the producers would consider adequate. Although it does not have personal knowledge, Transco suspects that other pipelines are similarly situated. The Commission has conceded that the pipelines it refers to in the Final Rule have potential take-or-pay exposure that is far in excess of the amount of past liability which they have been able to settle to date. Indeed, the Commission observed that the interstate pipeline industry has estimated that potential exposure to take-or-pay claims for gas not taken is approximately $7 to 10 billion. Transco has estimated its past take-or-pay exposure to be approximately $500 million as of July 31, 1985, and that by the end of 1985, such potential obligations could approximate several hundred million dollars more, even in the absence of open access transportation. Therefore, the Commission should be under no illusions: the Statement of Policy has not provided — and will not provide — a satisfactory solution to the enormous take-or-pay problem that still exists in the natural gas industry.

Even assuming that Transco and other pipelines could obtain sufficient funds to buy out take-or-pay demands of the magnitude claimed by producers, the Statement of Policy does not provide any assurance that such payments and associated costs could be included in the pipelines' rates. Transco believes that those amounts would be properly includable as costs incurred in providing service to its customers, and that the Commission could not justify excluding those costs. However, unlike the NOPR proposal, the Statement of Policy includes no presumption of prudence as to negotiated take-or-pay payments.

The Commission has also closed its eyes to another critical aspect of take-or-pay buyouts even assuming they could be made and recovered in rates -- the effects that would be felt in the marketplace. The costs of such buyouts would be high, and given the current competitive situation, the marketplace simply cannot absorb any increased costs. It is evident that take-or-pay buyouts — coupled with market-oriented pricing —

necessarily would result in lower prices to producers to offset the cost of the take-or-pay amounts. The Commission has failed to evaluate the likely impacts of such a course of action on, for example, the availability of future gas supplies.

Much attention has been focused on the published reports concerning Columbia Gas System's proposal to make payments of $800 million to certain of its producers over a 25-month period in exchange for take-or-pay and price concessions under problem contracts. Some seem to believe that Columbia's action demonstrates that contract buy outs constitute a workable solution to the take-or-pay problem.

I have already outlined Transco's views on the infirmities of the buy out approach to solving Transco's take-or-pay problems. Whether Columbia's gamble in pursuing that route will ultimately pay off remains to be seen.

If published reports concerning these recent settlements by Columbia with its producers are correct, however, those settlements have not resulted in a "buy out" of the contracts involved. Aside from unspecified price concessions, Columbia has succeeded in only reducing its take-or-pay obligations under those contracts (from as high as 90 percent of deliverability down to 50 percent), not in eliminating such obligations. Columbia appears to recognize that its customers must be willing to purchase sufficient quantities from it to enable Columbia to meet these settlement obligations. This strategy was revealed in a petition filed by Columbia with the Commission which seeks the Commission's approval of a requirement that Columbia's "open access" transportation obligation be coupled with a minimum purchase obligation on the part of customers from Columbia's system supply. Indeed, it seeks this approval as a condition to Columbia's agreement to commit to open access on a long-term basis. The Commission's Final Rule clearly prohibits such a requirement.

As I have previously stated, under the Commission's "open access" rule as it now stands, pipelines are subject to the potential loss of virtually all their sales because their distribution customers have no obligation under the Final Rule to continue any level of purchases. If Columbia elects to provide access in the manner reflected in the Commission's Order No. 436, Columbia is faced with this very real prospect. Should Columbia somehow convince the Commission of the legality of its proposal to tie transportation access to minimum purchase obligations, then presumably the Commission will modify its order so as to enable all pipelines to require minimum purchase obligations from its customers. Thus, the "open access" envisioned by many would be emasculated.

The Commission should not delay any longer. It must squarely address the take-or-pay problem confronting the industry. On rehearing of the Final Rule, the Commission should require any producer desiring to take advantage of open access transportation to relinquish all past and present take-or-pay claims against all pipelines to which it sells gas so long as it is utilizing the transportation services. This would result in a more equitable balancing of markets and supply. Under the Final Rule as presently promulgated, the producer would enjoy the best of all possible worlds. It is able to compete directly in the marketplace for sales traditionally made by pipelines and to displace those sales. At the same time, the producer retains its take-or-pay claims against pipelines who are unable to market their gas in this new environment. In fact, it is capable of exacerbating the problem by claiming take-or-pay resulting from the very sales it is displacing. The pipeline is caught in the middle and must contend with loss of sales markets and increased take-or-pay exposure. The Commission unquestionably has the authority to condition a producer's access to open transportation upon a release of take-or-pay claims, and such action is an essential and important step toward solving the industry's take-or-pay problems.

While the Commission's goal of restructuring the industry to improve market signals and better balance supply and demand is a laudable one, there simply is no rational justification to exclude producers' gas purchase agreements from that restructuring process. However, neither the Statement of Policy nor the absence of a block billing rule on a contemporaneous basis gives the necessary impetus for producers to renegotiate their contracts.

In summary, the Final Rule in its present form changes only half of the equation. It allows customers of pipelines who elect to provide open access transportation to play the spot market in lieu of their existing purchase contracts and to reduce and ultimately eliminate their firm contractual entitlements, but gives no relief to the pipelines under the corresponding contracts with producers. The Commission has the authority to remedy that situation and must exercise that authority to provide the fair treatment to all segments of the industry.

* * *

As stated at the beginning of my testimony, based upon Transco's evaluation of the impact of the Final Rule on its business, Transco has reluctantly concluded that it cannot responsibly become an "open access" transporter at this time. Transco believes that if it were voluntarily to adopt "open access" transportation, its customers would replace purchases of Transco's gas with gas purchased elsewhere, resulting in substantially reduced, if not totally precluding, purchases from Transco's producers. Consequently, Transco's potential exposure to claims by its producers for take-or-pay, drainage, loss of related oil production, and well or reservoir damage would increase dramatically. And even if the costs associated with any successful assertion of such claims could be passed on to Transco's customers, it would increase gas costs far more than Transco believes would be in the long term best interests of the industry.

As I have previously stated, while it is difficult to quantify accurately the potential exposure facing Transco were it to elect to provide "open access" transportation and the block billing implemented, Transco estimates that its take-or-pay exposure alone, not considering other potential contract claims, could be in the range of $6 billion for 1986 and 1987.

Transco filed a Petition for Rehearing of the Final Rule with the Commission on November 8, 1985 (copy attached as Exhibit B), which sets forth the necessary modifications to the Rule that Transco believes are vital to enable the industry to move toward a more market-driven orientation, without placing any segment in jeopardy of future survival. Most of the views I have expressed today on the Final Rule are presented to the Commission in that petition.

Transco has also notified its producer-suppliers and its customers of its decision not to proceed under the "open access" option at this time and the reasons for that decision (copies of correspondence to Transco's producers and customers are attached as Exhibits C and D, respectively).

Consequently, pursuant to the Final Rule many transportation arrangements for "spot gas" ceased on October 31, 1985. During October, 1985, Transco transported an average of over 1.5 billion cubic feet per day of "spot" gas to the market areas served by its system. After October 31, 1985, "spot" gas volumes transported to the market area by Transco under arrangements "grandfathered" by the Final Rule fell to an average of slightly less than 1.0 billion cubic feet of gas per day.

With respect to interruptible transportation of "spot" gas supplies under arrangements continuing beyond October 31, 1935, Transco's general policy is to require that such transportation service be for loads or markets that would not otherwise be served by gas under Transco's firm sales rate schedules. This requirement is essential in order for Transco to mitigate the adverse effects that reduced sales have on its purchases under long-term contracts with producers containing take-or-pay provisions.

On November 8, 1985, a Commission Administrative Law Judge issued a lengthy decision concerning, among other things, the availability of interruptible transportation services on Transco's system. While in due course we will be expressing some disagreements with various aspects of the Judge's decision -- which is subject to Commission review -- it is important to emphasize that the Law Judge recognized the very point which Transco has been stressing, namely, that customers cannot expect the pipeline to continue its merchant function if the customers also are able to switch freely from gas sold by the pipeline to gas transported on the "spot" market. A brief passage from the Judge's decision makes this point:

> "There is simply no justification to guarantee service from Transco on the one hand, and allow these customers to switch off the system below their contracted volumes when it is more profitable to do so."

The Judge's solution was to require the customer to purchase all of its contract volumes from Transco before becoming eligible for interruptible transportation service. Transco believes that this solution is extreme because it goes much farther than is necessary in recognizing the distributor's purchase obligation and the pipeline's sales obligation. Transco's policy has been more favorable to transportation service because Transco is willing to transport "spot" gas for customers even when they haven't purchased at full contract levels, but only so long as a sale is not being displaced.

Transco's reduced ability to transport "spot" gas has had an impact on both its producer-suppliers and its customers. Our producers have suffered reduced production levels and revenue. Our customers have been forced to look elsewhere for "spot" gas supplies, supplies which in certain instances are no longer available. For example, prior to October 31, 1985, Transco had been transporting "spot" gas to an end-user in Pennsylvania. That transportation arrangement was not "grandfathered" under the Final Rule and Transco was therefore unable to continue to transport that end-user's "spot" gas after October 31, 1985. That end-user has been forced to obtain an alternative source of more expensive gas, and has advised Transco that its plant is in very real danger of closing. As a result, an estimated 700 of Pennsylvania's citizens are very close to becoming unemployed.

The Commission's failure to squarely address the serious take-or-pay problem is apparently based upon its concern that it lacks the statutory authority to do so. Although Transco is not alone in its belief that the Commission has such authority, there is no question that the Congress clearly has the jurisdiction and authority to affirmatively act and resolve this problem. We urge this Subcommittee to seriously consider the efforts of INGAA to seek corrective legislation to benefit the public interest.

Transco remains firm in its intention to ultimately cease performing the merchant function of buying and reselling gas so as to engage primarily in transportation, storage and other related services, with gas sales being made by non-jurisdictional entities. Transco hopes that through corrective action, either on rehearing of the Final Rule or through legislative means, which restructures the relationships between local distribution companies, pipelines and producers, Transco will be able to move aggressively into the transportation function. Having been in the forefront of the movement toward increasing the transportation function, Transco desires to continue in that direction when reasonably enabled to do so.

In closing, I would like to again thank this Subcommittee for offering me the opportunity to present Transco's views on the most significant and dramatic regulatory change in the natural gas industry since the passage of the NGA.

EXHIBIT A

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DEPARTMENT OF ENERGY
BEFORE THE
Federal Energy Regulatory Commission
WASHINGTON, D. C.

Regulation of Natural Gas Pipelines and Partial Wellhead Decontrol	)))	Docket No. RM85-1-000 (Parts A-D)

EXECUTIVE SUMMARY TO COMMENTS OF TRANSCONTINENTAL GAS PIPE LINE CORPORATION ON NOTICE OF PROPOSED RULEMAKING

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July 15, 1985

DEPARTMENT OF ENERGY
BEFORE THE
Federal Energy Regulatory Commission
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Regulation of Natural Gas Pipelines and Partial Wellhead Decontrol	)))	Docket No. RM85-1-000 (Parts A-D)

EXECUTIVE SUMMARY TO COMMENTS OF TRANSCONTINENTAL GAS PIPE LINE CORPORATION ON NOTICE OF PROPOSED RULEMAKING

This Executive Summary and the comments it relates to are filed on behalf of Transcontinental Gas Pipe Line Corporation (Transco) pursuant to the Notice of Proposed Rulemaking (NOPR) issued by the Commission in this docket on May 30, 1985.

The NOPR represents the most sweeping regulatory proposal to restructure the natural gas industry since the infancy of this now mature industry. There can be no question that the essential purposes of the NOPR are more than simply desirable -- they are essential to the continued viability of the industry. Fair competition on a "level playing field," if it can be achieved, will give even greater play to the innovative capabilities of the industry. Proper incentives for all segments of the industry will be necessary to achieve this goal. While the Commission's intentions cannot be faulted, however, there exist a number of shortcomings in the NOPR which must be addressed and rectified in the final rule or rules to be adopted.

Set forth below is a summary of Transco's position and suggested recommendations on each of the four main aspects of the NOPR.

A. Proposed Three Block Pricing

With respect to the one assertedly non-optional aspect of the NOPR, Transco does not endorse the proposed deviation from rolled-in pricing, although it fully agrees with the Commission's objectives to signal producers to renegotiate non-market-responsive contracts. On the assumption that the Commission intends to go forward with its mandatory block pricing scheme, however, Transco makes two major recommendations:

- First, Transco strongly urges that the Commission's proposed Block 2 be subdivided in such a way as to create a separate subcategory of gas for all new gas purchase contracts entered into after the effectiveness of the NOPR and for all previous contracts which either now have or become market responsive on a permanent basis and that sub-block of gas be first offered for sale to existing customers. Further, if the non-discriminatory transportation option is accepted by a pipeline, such subcategory of market responsive gas should be considered eligible for transportation under that authority and, where necessary, blanket abandonment and certificate authority should be granted as part of the rule that is adopted.

- Second, the Commission should make it clear that the determination as to the production of gas from the blocks is sequentially mandatory, i.e., that if the customer nominates its share of available Block 1 gas, the pipeline is required to call upon its Block 1 gas from its producer-suppliers as so nominated, and the pipeline is then required to have produced next the market responsive subcategory of Block 2 gas. Otherwise, the block pricing scheme simply will not work and will not provide the needed incentive to producers to renegotiate their high-priced contracts.

B. Non-Discriminatory Transportation

Transco's main observations, comments, and recommendations on the open transportation option of NOPR are as follows:

- Transco believes that pipelines ultimately should shed the role of providing the merchant function, consistent with the underlying premise of this section of the NOPR.

- The most essential feature of an open transportation program -- if it is to be at all workable -- is a truly viable method of addressing the take-or-pay problems. The NOPR's buy-out proposal is not a workable answer (see, Part C, infra).

- Any customer which desires to reduce its contract demand without the consent of the pipeline should be required to substitute an equal amount of firm transportation whether he avails himself of a long-term purchase contract with a producer or relies upon firm self-implementing service and should pay the same standby or demand charges and minimum bills (less gas costs) as sales customers presently pay. Conversely, any customer which wishes to receive firm transportation service should be required to reduce its contract demand level by an equivalent amount.

- The Commission's proposed option to render firm transportation service cannot be implemented on most pipeline systems, and certainly not on Transco's system, unless customers in fact give up existing contract obligations. Transco's system is fully allocated on a firm basis and, since expansion is not contemplated for the conversion process, there needs to be an incentive to induce distributors to convert to firm transportation. Transco would recommend that an incentive to do so would be to allow customers to maintain their full share of Block 1 gas so long as the reduced purchase contract will accommodate that amount of gas.

- The Commission's volumetric rate proposal for transportation is a radical departure from historical rate concepts in the pipeline industry and should not be adopted for numerous reasons.

C. Payment in Lieu of Take-or-Pay Obligations

With respect to the Commission's "buy-out" concept for take-or-pay, Transco sees that proposal to be totally unworkable. Transco's observations and recommendations with regard to this aspect of the Commission's proposal are as follows:

- Under any scenario, the amounts Transco would have to finance in order to take advantage of the buy-out provisions would be staggering and it is virtually certain that Transco could not finance such amounts. This assumes, first of all, that the Commission will modify its proposed regulations and will subcategorize Block 2 gas supplies, creating a separate category for contracts containing market-responsive prices. Transco believes that there would be no demand for gas beyond production of Block 1 and the market-responsive Block 2 gas supplies. Thus, for its non-market responsive gas under the proposed formula Transco's take-or-pay exposure is estimated to be about $6 billion and virtually all of would be nonrecoupable. Assuming that only 10% of this potential liability were paid by Transco to buy-out take-or-pay and minimum take obligations, it would require the financing of payments of about $600 million, which is about 40% of Transco's current rate base.

- Additionally, Transco estimates that its stockholders would absorb about $135 million, after taxes, in carrying costs over the five-year period and its rates would increase about 12¢ per dt on the assumption that the foregoing $600 million could be financed. Aside from the losses which Transco would face, the latter effect would be counterproductive to the objective of reducing gas prices to market clearing levels.

- Adoption of the proposed buy-out provision would effectively require producers to enforce the provision and would totally eliminate the ability of pipelines to negotiate take-or-pay settlements as they have been able to do heretofore, albeit only on a temporary basis. Thus, the adoption of the buy-out provision would be an extremely negative step in the view of the pipelines in terms of negotiating with producers.

- Because the buy-out provision is totally unworkable and because an effective solution to take-or-pay problems is essential to the working of the optional transportation programs, Transco suggests that a viable alternative would be to require that any producer desiring to avail itself of nondiscriminatory transportation must waive all past and prospective take-or-pay or other minimum take claims against each pipeline with whom it has a gas purchase contract or, at the producer's option, cancel the contracts. A waiver of claims as to all pipelines (or cancellation of contracts) is necessary to ensure take-or-pay relief and equal access. Requiring a producer to relinquish existing take-or-pay claims only if the producer wishes to gain access to the non-discriminatory transportation programs would ensure that end-users, pipelines and producers are all playing on a "more level playing field."

D. The Optional Expedited Certificate Procedure

It is difficult for Transco to imagine any substantial circumstances in which these alternate/optional certificate procedures would be attractive, particularly with volumetric rates. As with other aspects of the NOPR, there is a basic incongruity between the Commission's stated intentions and how the proposed optional certificate procedure actually would operate. The Commission's proposal stops short of providing any true incentives of the free market environment which ostensibly is the goal of the optional certificate procedure, assuming free market incentives are lawful under the Natural Gas Act. Given the lack of any true opportunity to reap the rewards which should be attendant with shouldering full risks of an undertaking, it is very doubtful that the optional certificate procedure (as now constituted) would be utilized except for projects with relatively modest capital costs.

Respectfully submitted,

TRANSCONTINENTAL GAS PIPE
LINE CORPORATION

By Thomas F. Ryan Jr.
Thomas F. Ryan, Jr.
Its Attorney

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Regulation of Natural Gas)
Pipelines and Partial Wellhead)
Decontrol)

Docket No. RM85-1-000
(Parts A-D)

COMMENTS OF TRANSCONTINENTAL GAS PIPE LINE CORPORATION ON NOTICE OF PROPOSED RULEMAKING

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July 15, 1985

DEPARTMENT OF ENERGY
BEFORE THE
Federal Energy Regulatory Commission
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Regulation of Natural Gas Pipelines and Partial Wellhead Decontrol	)))	Docket No. RM85-1-000 (Parts A-D)

COMMENTS OF TRANSCONTINENTAL GAS PIPELINE CORPORATION ON NOTICE OF PROPOSED RULEMAKING

I.

PRELIMINARY STATEMENT

The Notice of Proposed Rulemaking (NOPR) issued in the captioned docket on May 30, 1985 appears to be based upon recognition by the Commission of the following facts:

(1) Pipelines have been generally unable to renegotiate their high-priced, high take-or-pay gas purchase contracts except on a temporary stop-gap basis.

(2) There is a surplus of deliverable supplies committed to many pipeline systems which has not only created take-or-pay problems for those pipelines but has precluded any significant outlets for new gas supplies currently being found by producers.

(3) The surplus of existing commitments to pipelines — and the concomitant inability of producers to market through traditional channels to pipelines — has caused uncommitted gas to be offered on better terms and at lower prices than the high-priced "problem" contracts entered into by pipelines in the 1970's, some of which are still regulated under the Natural Gas Policy Act at maximum lawful prices considerably above market clearing levels. For example, "spot" gas prices have fallen

to less than $2.40 per dt in the Gulf Coast area this summer, while Section 102(d) gas carries a current "regulated" price of $4.022 per dt and tight sands gas regulated under Section 107(C)(5) is as high as $6.034 per dt.

(4) There has been a widespread clamor by practically everyone, except the beleaguered pipelines, for greater access to the cheap new gas supplies which are available at low prices because of the temporary glut of supply. Since pipelines have been traditionally required to price their sales on the basis of rolled-in gas purchases, not only would acquisition by pipelines of new, cheaper supplies exacerbate the existing surplus and take-or-pay problems, its impact on average gas costs would be substantially diluted. Thus, the clamor has become one for greater access to transportation. Somewhat understandably, end-users, distributors, state commissions, and elected representatives in Congress have placed enormous pressures on pipelines and the Commission to open up transportation and somehow find a way to bring currently committed supplies in line with current market realities. 1/ Less understandably, the producing segment of the industry has joined forces with the consumer interests in exerting pressures on pipelines for "open" transportation while at the same time many of them are refusing to deal with the high priced, high take-or-pay contracts on a permanent basis.

Faced with the foregoing circumstances and the failure of Congress to act to cure those deficiencies in the NGPA which would rid existing gas purchase contracts of onerous take-or-pay provisions and indefinite pricing clauses, the Commission has adopted the proposed comprehensive restructuring of the industry in a package of proposals contained in the NOPR.

1/ In Transco's view, the overwhelming pressures placed on pipelines by consumer interests for more open transportation to replace sales have been based solely on short-term considerations without regard to the long-term consequences of such actions to the well-being of the entire industry. Nevertheless, these pressures are real and they are obviously felt by the Commission and its Staff.

At the outset, Transco wishes to commend the Commission for a product which obviously has required a great deal of thought, ingenuity and hard work in an effort to set the industry straight and accomplish the objective of making gas markets truly competitive. However, Transco believes that certain fundamental changes must be made in the various aspects of the NOPR if it is going to have a chance at succeeding in its objectives and, even then, Transco is deeply concerned about the impact which this proposal will have upon the pipeline and distribution segments of the industry. As a consequence, while Transco's comments are intended to offer constructive suggestions for changes in major areas, Transco is compelled to preserve all of its legal rights to challenge the various aspects of the proposal which are ultimately adopted.

Because of the short time provided for comments on such a complex set of far-ranging proposals, and because it is anticipated that the Commission will be overwhelmed with the sheer numbers of documents filed in response to the NOPR, Transco has worked closely with the two trade associations to which it belongs, namely, the American Gas Association (AGA) and the Interstate Natural Gas Association of America (INGAA), and agrees with most of the changes recommended in the comments being filed by those associations. Transco's emphasis in the area of "optional" transportation is somewhat different, because Transco believes that it will not be possible reasonably to blend over the long-term the sales and transportation functions. Consequently, Transco would emphasize the need to adopt a rule which would create a total conversion from pipeline sales to pipeline contract carriage and storage. Otherise, the recommended changes in the NOPR which are made by AGA and INGAA are remarkably similar and show a degree of unanimity of views between the pipeline and distributor segments of the industry which has not existed in recent years.

Therefore, Transco not only supports in principal the changes recommended by AGA and INGAA in principal recommended by the AGA and INGAA, but urges the Commission to pay particular attention to the comments of those two associations.

In light of the foregoing, Transco has attempted to highlight here only its views of the direction this industry should take and the crucial aspects of the NOPR which it believes must be revised to give it a chance to succeed. Additionally, Transco would urge that, because of the numerous questions of interpretation and operation of many facets of the NOPR, particularly the open transportation and optional certificate program and the rate aspects thereof, a series of public conferences be scheduled subsequent to the August 1, 1985 conference and prior to adoption of any rule or rules so that further clarification and amplification of these options may be developed. 2/

II.

STATEMENT OF TRANSCO'S POSITION ON MAJOR ASPECTS OF NOPR

A. Proposed Three Block Pricing

In making its comments, Transco is assuming that the Commission intends that its proposed Block 3 does not include rates currently billed in the demand charge component of a pipeline's rates either directly or on an as-billed basis from upstream pipeline suppliers. Otherwise, a total reshuffling of pipelines' rate structures would be required and such an undertaking could not possibly be accomplished in the reasonably

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2/ Although not on all fours with the situation which existed when the NGPA was passed because the Commission was obliged to place into effect interim rules, the series of conferences held thereafter were of immeasurable benefit in making the final rules understandable and workable.

foreseeable future. 3/

Transco does not endorse the proposed deviation from rolled-in pricing, but recognizes that the Commission's objective in proposing to place "forever-regulated" gas in a separate block from the higher-priced categories is intended to produce a more level playing field with respect to competition for markets and to use market pressures to induce producers to renegotiate their higher priced contracts so that they become independently marketable and not marketable solely because they are masked by the rolling-in of lower cost supplies.

On the assumption that the Commission intends to go forward with its mandatory block pricing scheme, Transco would make two major recommendations. First, Transco strongly urges that the Commission's proposed Block 2 be subdivided in such a way as to create a separate subcategory of gas for all new gas purchase contracts entered into after the effectiveness of the NOPR and for all previous contracts which either now are or through renegotiation become market responsive on a permanent basis and that such sub-category of gas be first offered for sale to existing

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3/ If this understanding is correct, then a further "leveling" of the playing field, which is stated to be the principal objective of block pricing, would be for the Commission to act concurrently in pending rate cases to provide for a more uniform method of rate design among pipelines. For example, Transco's two major competitors in the principal part of its market area, namely, Tennessee Gas Pipeline Company and Texas Eastern Transmission Corporation, are operating or are authorized to operate under modified fixed-variable rate structures, while Transco must await a decision on this issue in Docket No. RP82-55, the initial decision in which was issued on September 28, 1984. Perhaps, since the NOPR represents such a sweeping restructuring of the industry, the Commission should consider adding a provision that all pipelines not currently on modified fixed-variable rates should be permitted to restructure existing rates and place into effect, concurrently with the implementation of the rules, modified fixed-variable rates based upon the principles enunciated in the *Natural* and *Texas Eastern* cases. See, Texas Eastern Transmission Corp. 30 FERC ¶ 61,144, *reh'g granted for purposes of further consideration*, 31 FERC ¶ 61,049 (1985); Natural Gas Pipeline Company, 25 FERC ¶ 61,176 (1983), *reh'g denied* 26 FERC ¶ 61,203 (1984), *appeal docketed sub nom.* Northern Indiana Public Serv. Co. v. FERC, No. 84-1416 (7th Cir. March 19, 1984). This would also have the beneficial effect of making underutilized contract quantities more costly and an inducement to restructure. See footnote 5, *infra*.

customers. Further, if the non-discriminatory transportation option is accepted by a pipeline, such subcategory of market responsive gas should be considered eligible for transportation under that authority and, where necessary, blanket abandonment and certificate authority should be granted as part of the rule that is adopted. If such a subdivision of market responsive gas is not adopted, the producer whose contract is currently market responsive would be penalized if the resulting Block 2 price is still not marketable and there would be little, if any, incentive for a producer to renegotiate its contracts to become market responsive if the result is that the average price of the entire block is still too high to be marketable. Conversely, there would likewise be little, if any, incentive for a high-cost producer to renegotiate if the particular pipeline's average cost in Block 2 were sufficiently low to be marketable.

Second, the Commission should make its intent clear that the determination as to the production of gas from the blocks is sequentially mandatory, i.e., that if the customer nominates its share of available Block 1 gas, the pipeline is required to call upon its Block 1 gas from its producer-suppliers as so nominated, and the pipeline is then required to have produced next the market responsive subcategory of Block 2 gas. Otherwise, the block pricing scheme simply will not work and will not provide the needed incentive to producers to renegotiate their high-priced contracts.

B. Non-Discriminatory Transportation

At the outset, Transco wishes to reiterate the position which it previously announced in its comments on the Notice of Inquiry in the instant docket, namely, that Transco believes that pipelines ultimately should shed the role of providing the merchant function of buying and selling gas and instead should become totally transportation and storage service companies. In Transco's judgment, it is not feasible to combine the selling and transportation functions in such a way that pipelines become, as one of its customers put it, "sellers of last resort." Yet, that appears to be a potential outcome of the "optional" mandatory transportation proposal, when it is coupled with the option given to customers to reduce their contract levels without the pipeline's consent. 4/

It is Transco's strong recommendation that any customer which desires to reduce its contract demand without the consent of the pipeline 5/ should be required to substitute an equal amount of firm transportation whether he avails himself of a long-term purchase contract with a producer or relies upon firm self-implementing service and should pay the same standby or demand charges and minimum bills (less gas costs) as sales customers presently pay. Conversely, any customer which wishes to receive firm transportation service should be required to reduce its contract demand level by an equivalent amount. 6/ However, in order to make this system work in a rapid, orderly fashion, the Commission must adopt a viable means for solving the pipelines' take-or-pay problems which, as shown in the next section hereof, requires a means other than the Commission's proposed "buy-out" provision.

With respect to the option of customers to reduce contracts by as much as 25 percent per year for four years, it should be obvious that there would not be nearly enough new gas available to customers to substitute for such a major reduction in purchase contracts, even taking into account that a small portion of current gas

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4/ As noted above, Transco must preserve all of its legal rights in the event it appears that any final rules promulgated as a result of the NOPR will impair the pipeline's ability to function. In particular, Transco seriously questions the legality of the allegedly optional transportation option, the effective elimination of the transportation rights which are available under Section 311 of the NGPA without any certificate authority from the Commission by requiring a blanket certificate for all so-called "self-implementing" transportation (NOPR, p. 144) and the absolute right of the Commission to permit customers to abrogate contracts, certificates and service obligations without the consent of the pipelines.

5/ There are certain customers on Transco's system whose contracts should be reduced because of their low load factor operations and Transco has been attempting to get these customers to reduce their contracts for several years without success. Transco would consent to such reductions because it believes it could market the gas elsewhere.

6/ If an end-user wishes to avail itself of firm transportation, the same charges should apply and there must be a concurrent reduction in contract quantity by the customer formerly serving the end-user.

contract levels are surplus to customers' needs. As a consequence, most of such gas would have to come from purchase contracts presently dedicated to pipelines and to the extent those contracts can be assigned to and negotiated satisfactorily by the customers, there would be a concomitant relief of take-or-pay obligations on the part of the pipeline. This still would not solve the take-or-pay problems engendered by any new gas purchases by customers to replace long-term sales obligations, whether of the long-term purchase variety or of the "self-implementing" variety. 7/

The Commission's proposed option to render firm transportation service cannot be implemented on most pipeline systems, and certainly not on Transco's system, unless customers in fact give up existing contract obligations. 8/ Transco's system is fully allocated on a firm basis and, since expansion is not contemplated for the conversion process, there needs to be an incentive to induce distributors to convert to firm transportation. Transco would recommend that an incentive to do so would be to allow customers to maintain their full share of Block 1 gas so long as the reduced purchase contract will accommodate that amount of gas. 9/

The Commission's volumetric rate proposal, which pervades both the optional mandatory transportation proposal for firm service and the optional certificate

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7/ The Commission's recent decision in Transwestern Pipeline Company, Opinion No. 238, 32 FERC ¶ ____ (July 1, 1985), which wiped out Transwestern's minimum commodity bill will, if applied across the the board, further aggravate the take-or-pay problems of pipelines absent a viable take-or-pay solution.

8/ With respect to the discussion as to curtailment of such firm transportation, Transco assumes that this discussion applies only to capacity considerations since Transco must assume that the transportation customer is responsible for its own supplies. A pipeline could not be expected to have back-up reserves available to make up for failures of customers to maintain their own supplies, without also expecting the producers to charge substantial stand-by charges for such reserves, which charges would have to be passed on to the transportation customers.

9/ Transco understands that this recommendation differs somewhat from the recommendations of AGA and INGAA in this specific area.

procedure for new service, is a radical departure from historical rate concepts in the pipeline industry and, to the extent we understand it as it relates to transportation,[10] would not possibly permit a pipeline to recover the costs of rendering the firm services, in clear violation of the Natural Gas Act. It would also constitute a one-way street with the pipeline having all of the obligations to assure firm service while the customer would have no obligation to utilize or pay for it. There is certainly no justification for a departure from the traditional method of rate design embodied in firm rate schedules for sales and transportation,[11] except as modified for a uniform change in rate design,[12] nor as a practical matter will such a different approach to transportation rates be workable alongside traditional sales rate structures. Finally, aside from the serious legal and financial impediments to the volumetric rate approach, as a practical matter, each pipeline would require a full-blown rate case to develop "representative volumes" and other aspects of this radical departure.

Transco is also troubled by the apparent purpose of the optional mandatory transportation and optional certificate for new service programs to accelerate the

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10/ The specific language in proposed Section 284.7 is at best ambiguous because the maximum off-peak rate is an incremental cost rate which would not literally include any fixed costs, while the maximum peak rate is based upon fully allocated costs "less any fixed costs recovered in the ceiling rate for off-peak service." Also, Transco does not understand the difference between the "average variable costs" basis of the minimum rate and the "incremental cost" basis of the maximum off-peak rate. Finally, while the rule states that pipelines may continue to render interruptible transportation service, § 284.104(c)(ii), there does not appear to be a provision for an interruptible rate unless it is the election provided by § 284.103(c).

11/ See, e.g., Transco's Rate Schedules CD-1, CD-2 and CD-3 to First Revised Volume No. 1 of its FERC Gas Tariff and Rate Schedules X-11, X-42, X-52 and X-56 to Original Volume No. 2 of its Tariff.

12/ See footnote 3, supra

placement of more and more risk upon pipelines, which after all continue to be regulated under the Natural Gas Act which assures the opportunity, where prudent, to earn a reasonable return on their investment.[13] Yet, the main thrust of the NOPR appears to be that if the company is efficient, it will recover its costs but if it is inefficient, it will suffer losses. (See, e.g., NOPR, p. 27). But there seems to be no recognition that the super efficient firm should recover more than its costs, which is the way the unregulated market works, and the way that a free market should work[14] There is a passing suggestion that the Commission may adjust returns on equity to compensate for the increased risks of the restructured industry (NOPR, p. 25), but the NOPR is silent as to how or when this adjustment takes place and certainly is not clear that any such adjustment would be an adequate substitute for the free play of the market place.

C. Payment in Lieu of Take-or-Pay Obligations

As noted above, in order to make the open transportation option at all workable or even theoretically justifiable, a viable means of dealing with pipelines' take-or-pay obligations, which would be clearly exacerbated by any such open transportation, must become a part of the package. Unfortunately, as Transco sees it, the Commission's "buy-out" concept for take-or-pay would be totally unworkable.

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[13] FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942); Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia, 262 U.S. 679 (1923); See also, State of Missouri, ex rel Southwestern Bell Tel. Co. v. Public Service Commission, 262 U.S. 276 (1923).

[14] This assumes that the free market concept is lawful under the Natural Gas Act as it pertains to pipelines' sales and transportation rates and services.

Transco projects that nonrecoupable take-or-pay exposure incurred in 1986 and 1987 would be staggering. If even a small percentage of that amount would constitute the x and y factors which, if paid, would be presumptively prudent, and would in fact accomplish a buy-out of take-or-pay contracts, it is virtually certain that Transco could not finance such amounts. However, assuming, arguendo, that Transco were able to obtain the financing, the carrying costs on the unamortized payments which Transco's stockholders would have to absorb would seriously affect Transco's income over the five-year amortization period. Finally, if Transco were in a position to attempt to recover the amortization amounts in a rate case, the increase would be substantial and plainly counterproductive to one of the fundamental objectives of the NOPR, namely, to make gas prices competitive in the market place.

Under any scenario, the amounts Transco would have to finance in order to take advantage of the buy-out provisions would be enormous. While it is difficult to predict with precision the nonrecoupable take-or-pay liability Transco would incur in 1986 and 1987, Transco conservatively estimates that its exposure under the formula would be in the range of $6 billion. This assumes, first of all, that the Commission will modify its proposed regulations and will subcategorize Block 2 gas supplies, creating a separate category for contracts containing market-responsive prices. Transco believes that there would be no demand for gas beyond production of Block 1 and the market-responsive Block 2 gas supplies. Make-up can only occur as gas is produced and sold, and non-market-responsive contracts in Block 2 would not permit the sale of that gas. Thus, virtually all of the $6 billion of Transco's estimated potential take-or-pay liability would be nonrecoupable. Even a very low percentage of this $6 billion would be difficult to finance. For example, assuming that 10% of this potential liability were paid by Transco to buy-out take-or-pay and minimum take obligations, it would require the financing of payments of about $600 million, which is about 40% of Transco's current rate base.

The fact that the Commission proposes to deny recovery of the carrying costs on these sums would be an additional impediment to Transco's ability to obtain financing for payments of that magnitude and would seriously affect Transco's income over the five-year period. Moreover, it is difficult to see how the Commission can on the one hand find that take-or-pay buy-out payments are prudent, but on the other hand require Transco's shareholders to absorb the carrying costs on such amounts which are estimated to be $135 million over the five year amortization period.[15] This would seem to run contrary to the regulatory scheme contemplated by the Natural Gas Act.[16]

Putting aside for the moment the question of whether Transco could finance take-or-pay buy-outs and could absorb the losses of the carrying charges, there are other practical and legal infirmities inherent in the proposal. Transco's rates to its customers would be increased significantly, assuming Transco was in a position to file a rate increase. Again, assuming that 10 percent of Transco's potential nonrecoupable take-or-pay liability would be paid to producers, the amortization of one-fifth of $600 million would cause an increase in rates of approximately 12 cents per dt, even based upon the unrealistic assumption that Transco's total throughput capacity of approximately one Tcf were utilized on an annual basis. An increase in rates of that magnitude would significantly impact Transco's ability to compete in the marketplace and would be counterproductive to the objective of reducing gas prices to market clearing levels.[17] Additionally, implicit in the Commission's buy-out proposal is the assumption that nonrecoupable take-or-pay under NGPA price-regulated contracts would not be a violation of the Title I price ceilings. There are numerous petitions pending before the Commission on this subject and the Commission has failed to but should address the issue.

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[15] Such amount reflects the effective after tax costs of financing the buy-out payments assuming financing of debt and equity in the same ratios as Transco's current capital structure of 60 percent debt and 40 percent equity and assuming a 15 percent return on equity and a 10 percent cost of debt.

[16] Despite the Commission's citation of New England Power (NOPR at p. 99), Transco believes that case inapplicable to a situation where there is a Commission-sponsored program where the payments are determined in advance to be presumptively prudent.

Finally, adoption of the proposed buy-out provision would effectively require producers to enforce the provision and would totally eliminate the ability of pipelines to negotiate take-or-pay settlements as they have been able to do heretofore, albeit only on a temporary basis. Thus, the adoption of the buy-out provision would be an extremely negative step in the view of the pipelines in terms of negotiating with producers.

Because the buy-out provision is totally unworkable and because an effective solution to take-or-pay problems is essential to the working of the optional transportation programs, Transco suggests that a viable alternative would be to require that any producer desiring to avail itself of nondiscriminatory transportation must waive all past and prospective take-or-pay or other minimum take claims against each pipeline with whom it has a gas purchase contract or, at the producer's option, cancel the contracts. A waiver of claims as to all pipelines (or cancellation of contracts) is necessary to ensure take-or-pay relief and equal access. For example, a given producer may have contracts with pipelines A, B, and C, and may be able to obtain transportation from pipeline A for a large portion of its production. The producer

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17/ As written, the NOPR seems to contemplate a complete buy-out of take-or-pay obligations for the remainder of the contract. If this is the purpose, Transco questions whether any producer would be willing to take less than the discounted cash flow value of his reserves which would be an astronomical amount. If this is not the case, but is merely intended to buy-out two years of potential liability, then all of the foregoing adverse consequences would prevail and the long-range take-or-pay consequences would still remain with no incentive on the part of the producer to do anything beyond that period in contemplation of a series of two year buy-outs and no production.

would then be in the enviable position of marketing its production, and at the same time maintaining its take-or-pay claims against pipelines B and C. Requiring a producer to relinquish existing take-or-pay claims only if the producer wishes to gain access to the non-discriminatory transportation programs is consistent with the goals of the NOPR. It would ensure that end-users, pipelines and producers are all playing on a "more level playing field."

The foregoing is not to suggest that reasonable take-or-pay provisions are inappropriate. Obviously, under the revised industry structure envisioned by Transco where pipelines become solely transporters, it is assumed that long-term contracts with distributors will contain such reasonable provisions. Producers cannot be expected to be "sellers of last resort" under long-term arrangements any more than pipelines can. Transco makes this recommendation only because many producers, while being unwilling to negotiate any long-term solution to the take-or-pay problems, are clamoring to replace with transportation of new supplies the sales under existing contracts that would alleviate take-or-pay claims — the "have your cake and eat it too" approach.

D. The Optional Expedited Certificate Procedure

The remaining part of the Commission's NOPR package entails an optional certificate procedure which, according to the Commission, is designed to give pipelines greater flexibility (i.e., ease of entry and exit as regards new and/or expanded markets) while also holding pipelines "accountable" by putting them at risk for their decisions to respond to the new market opportunities presented by the flexible certification procedures. Like the other aspects of NOPR, this optional certificate procedure is commendable in concept and intent, but as a practical matter there are serious shortcomings which the Commission should consider and rectify in promulgating any final rule.

The Commission has proposed that any pipelines opting for the new certificate procedure in order to render transportation service would be required to provide "firm" transportation service to all other shippers at volumetric rates. Thus, insofar as it parallels the similar requirements of the open transportation part of NOPR, the optional certificate procedure raises the same concerns and entails the same infirmities as discussed hereinabove with respect to open transportation. For the sake of brevity, these matters will not be repeated, except to note that for any significant investment the absence of a demand charge or any obligation on the part of the customer to take or pay for any quantities magnifies the risks to the pipelines.

As with other aspects of the NOPR, there is a basic incongruity between the Commission's stated intentions and how the proposed optional certificate procedure actually would operate. The Commission's premise is that greater exposure to free market risks will act as an incentive for the pipelines to make better, more rational business decisions insofar as design and construction of new facilities is concerned. Apparently, the Commission believes that this new element of "accountability" is an adequate — and lawful — surrogate for the Commission's regulatory responsibilities under Section 7 of the NGA. Quite aside from the unsupported inference that pipelines have been behaving less optimally or efficiently in the present regulated environment because of the "full protection of a Section 7 proceeding," 18/ the Commission's optional certificate proposal does not offer a realistic remedy for any presumed inefficiencies of the present regulatory scheme. This is so because the Commission's proposal stops short of providing any true incentives of the free market environment which ostensibly is the goal of the optional certificate procedure, assuming such free market incentives are lawful under the Natural Gas Act. While there exist threshold questions as to the Commission's legal authority to depart from cost-based regulation in favor of rates based on market forces, 19/ here the Commission has not even attempted to provide the upside earnings potential for those

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18/ NOPR, p. 40.

19/ See INGAA's comments at pp. 9-10.

pipelines willing to take on added risks.

In short, the Commission has proposed a procedure designed to entice pipelines to take added risks, but without at the same time providing an opportunity to realize commensurate rewards. This inability to earn more than a traditional cost-based rate — coupled with the very high probability of earning substantially less than even a regulated rate of return — is a function of the proposed requirements and/or restrictions as to rates for services rendered pursuant to optional expedited certificates: (a) volumetric rates; (b) the use of "representative volumes" (which can never be reduced) to establish rates; (c) "properly allocated" cost-based rates; and (d) prohibition against minimum bills, demand charges or revenue guarantee provisions of any sort.

Given the lack of any true opportunity to reap the rewards which, in a free market environment, would be attendant with shouldering full risks of an undertaking, it is very doubtful that the optional certificate procedure (as now constituted) would be utilized except for projects with relatively modest capital costs, if even then. It is difficult for Transco to imagine any circumstances in which these alternate procedures would be attractive. Thus, Transco submits that the objectives of the optional certificate procedure are illusory and will not be achieved. Obviously, assuming arguendo the legality of such an approach, if the Commission intends that this procedure be meaningful and workable, it must remove the artifical restrictions to free market profit opportunities and thereby reconcile the practical impact of the optional procedure to its stated purpose.

E. Miscellaneous Comments

1. Timing of Effectiveness of Rule

The Commission requests comments on the effectiveness of the proposed rule (NOPR, p. 52). At the same time, it proposes that beginning as early as October 1, 1985, pipelines must notify their customers of their entitlements to block 1 gas for the year 1986 20/ and to reflect in their next PGA filing after the effectiveness of the rule the effect of block pricing. (NOPR, pp. 119-120, 194-195). In Transco's case, its next PGA filing is scheduled to be filed by October 1, 1985 to be effective November 1, 1985. Thus, because of the time required to prepare a PGA filing, it is unlikely to be able to implement block pricing, if the Commission adopts it, before its May 1, 1986 PGA. This means that others, including competitors, will be making their filings effective well in advance of Transco. In order to "level the playing field" for everyone at the same time, Transco suggests that the Commission adopt a single date for a one-time PGA filing for all pipelines to implement block pricing, if ultimately ordered. Companies should be given adequate time after the rule is promulgated to segregate their supplies by blocks and attempt to negotiate with the producers in the non-market responsive block to make more gas marketable prior to the effectiveness of the PGA. Transco would recommend that a period of sixty days after the rule is issued should be provided for negotiations, preparation and filing of the one-time PGA. Thus, if the rule issues prior to October 1, 1985, an effective date of January 1, 1986 for the one-time PGA should apply to all pipelines.

With respect to the effectiveness of the "optional" transportation, this portion of the rule could be adopted quite promptly if the rate structures for firm transportation recommended by Transco are adopted, namely, sales rates less cost of gas, because existing sales tariffs could be readily converted to transportation tariffs without a Section 4 proceeding. If, however, the Commission adopts volumetric rates for firm transportation, Transco perceives that it will be a long time before agreement can be

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20/ There is also a provision that the formula for such Block 1 entitlements can be different than proposed in the NOPR if there is unanimous agreement between the pipelines and its customers for a different formula (NOPR, p. 47). If there were ever a chance that such an agreement could be reached, it is a virtual certainty to fail with such a tight time schedule, particularly when it is not known when the rule will ever issue or in what form it will issue.

reached or litigation can be concluded as to "representative volumes" or rate levels.

With respect to the optional certificate procedure, this again could be made effective rather promptly, but for the program to be effective to any significant degree, changes in the rate approach must be adopted in line with suggestions of AGA, INGAA, Transco and presumably many others.

2. Classification of Various Items in Particular Blocks

As a general matter, Transco believes that, other than block 1 gas, all market responsive gas, including imports, should be placed in its recommended separate market-responsive block for all of the reasons previously stated.[21] With respect to specific items such as gas in system storage, apportionment among blocks of upstream fixed costs in the commodity charges and any other costs which the Commission might believe should be split among blocks, Transco believes that open technical conferences among the affected parties and FERC staff should be held to resolve these matters prior to implementation of block pricing. System storage gas costs are not as significant on Transco's system as on many others, because most of the storage on Transco's system is already "unbundled" and sold as separate storage services with customers purchasing the gas for injection under Transco's regular rate schedules for injection into storage.[22] However, a method must be derived for dividing the gas costs in storage among blocks and it is Transco's belief that this method can be achieved through technical conferences. The same is true of upstream fixed costs in the commodity charges reflected in PGA's and, if any, other costs which the Commission intends to reflect in its Block 3.

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[21] With respect to the unique situation of Great Plains Gasification Associates, Transco's position is being reflected in the comments being filed simultaneously by Great Plains and the customer pipeline companies.

[22] Rate Schedules GSS, S-2, LGA, LSS and WSS to Volume 1 of Transco's tariff.

III.

CONCLUSION

Transco commends the Commission for its efforts to make gas markets work in a period of mostly deregulated gas costs but continued regulation of downstream pipelines and distributors. However, if the sweeping changes proposed by the Commission have a chance of success without crippling the interstate pipelines, certain fundamental changes, as suggested herein and in the comments of AGA and INGAA, must be made before promulgating a rule. Even then, the risks are extremely high and, consequently, Transco must preserve all of its legal rights and options upon the issuance of a rule.

Respectfully submitted,

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EXHIBIT B

DEPARTMENT OF ENERGY
BEFORE THE

Federal Energy Regulatory Commission

WASHINGTON, D. C.

Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol	)	Docket No. RM85-1-000

APPLICATION AND PETITION FOR REHEARING OF TRANSCONTINENTAL GAS PIPE LINE CORPORATION

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APPENDIX A

DEPARTMENT OF ENERGY
BEFORE THE
Federal Energy Regulatory Commission
WASHINGTON, D. C.

Regulation of Natural Gas)
Pipelines After Partial) Docket No. RM85-1-000
Wellhead Decontrol)

APPLICATION AND PETITION FOR REHEARING OF TRANSCONTINENTAL GAS PIPE LINE CORPORATION

Transcontinental Gas Pipe Line Corporation (Transco), pursuant to Section 19(a) of the Natural Gas Act (NGA), 15 U.S.C. § 717r(a), and Rule 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (Commission), 18 C.F.R. § 385.713, hereby requests rehearing of the Commission's Order No. 436 issued October 9, 1985 in the captioned docket.

In support hereof, Transco states as follows:

I.

PRELIMINARY STATEMENT

In its Comments to the May 30, 1985 Notice of Proposed Rulemaking (NOPR) herein, Transco agreed with the Commission's perception of the problems in the natural gas industry, the general objectives of the Commission in bringing gas prices under long-term contracts into line with market realities and making gas which is currently surplus available to consumers at low market oriented prices by means of increased transportation by pipelines. While not endorsing the concept of block billing, Transco suggested ways to implement such a concept without subjecting pipelines to the inevitable avalanche of take-or-pay claims by producers whose gas would be shut-in as unmarketable under a block billing mechanism. Additionally, Transco made constructive but necessary suggestions as to how open access transportation could be implemented without creating suicidal conditions for pipelines whose gas sales would be displaced.

Although it cannot be said that the suggestions of Transco were ignored by the Commission, it can safely be said that the principal suggestions were rejected in such a way as to almost deliberately place pipelines in jeopardy of future survival.[1] The Final Rule as adopted, as well as the block billing proposal as renoticed, if adopted, appear designed to expose pipelines to massive contract take-or-pay and damage claims by producers, whether the so-called "voluntary" open-access provision is accepted or not. Moreover, the reasons given for rejecting the major suggestions of the pipelines are wholly inconsistent with reasons given for adoption of other portions of the Final Rule, and the Final Rule — together with the renotice of the block billing proposal — reflects generally a bias against pipelines which makes it arbitrary, capricious and unlawful.

II.

SPECIFICATION OF ERRORS

Transco submits that the Commission's Order No. 436 is erroneous in the following respects:

1. The Commission erred by refusing to provide for take-or-pay relief as a necessary trade-off for open access transportation;
2. The Commission erred by unreasonably providing distributors with a unilateral right to revoke or convert their firm purchase contracts with their pipeline suppliers, without providing for take-or-pay relief for pipelines and considering the numerous potential adverse consequences of its action;

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[1] Transco was hardly alone in making its suggested changes to the NOPR. The American Gas Association (AGA), Interstate Natural Gas Association of America (INGAA), numerous pipelines and distributors, as well as such public bodies as the Public Service Commission of New York, made comments in many ways similar to those of Transco.

3. The Commission erred by splitting off, for future consideration and action, the block billing proposal from what it had steadfastly announced was an integrated package;

4. The Commission erred in promulgating rate conditions which not only are unlawfully vague, but appear to be designed to preclude pipelines from earning a fair return on investment;

5. The Commission's reliance on its prior Policy Statement as a purported resolution of take-or-pay problems is totally inadequate and makes the Final Rule unworkable and capricious;

6. The Commission erred in adopting expedited producer abandonment procedures as an apparent lever to coerce "least cost" purchasing practices; and

7. The Commission erred in promulgating an optional expedited certificate procedure which, as Transco understands it, repeats the errors of the open access transportation rate conditions.

III.

GROUNDS FOR REHEARING

A. The Commission's Refusal to Grant Take-or-Pay Relief In Return For Granting Producer Access to Open Transportation By Pipelines Cannot Be Supported

Perhaps the most egregious example of anti-pipeline bias in the Final Rule itself revolves around the Commission's refusal to grant take-or-pay relief under existing gas purchase contracts in return for granting to producers the right to sell directly to distributors and end-users and have transported by pipelines gas which producers cannot presently market in traditional channels. 2/ The final nail in the pipelines' coffin is inserted with the Commission's wholly unsupported "finding" that it would be unduly discriminatory for a pipeline to refuse to transport for a shipper in competition with its own sales. (See p. IV.A.49).

2/ Transco went further in its Comments and offered alternatively to relinquish entirely its high priced gas contracts with any producer which would prefer that course instead of granting take-or-pay relief.

First, let's discuss the predicament in which the Commission's open access provision places the pipeline industry if such "voluntary" option is accepted. Existing distributors may use any variety of options under the rule. They may choose to maintain their current contracts with pipelines, using those contracts as stand-by, and play the spot gas market for all of their supplies so long as spot gas quantities are available and the prices for such gas stay below the pipeline's commodity cost. The distributors may also choose to exercise their contract conversion or reduction options (which the Commission disingenuously says are really options agreed to by the pipeline as a condition for "accepting" a "voluntary" open access blanket certificate) and locate firm supplies from producers at total prices less than the price that would be paid to the pipeline.[3] Or, of course, the distributors may do some of each. In any event, the result is the same. The producers and the distributors have the best of all worlds, while the pipeline is left holding the bag; a bag which would consist of even greater surpluses of gas for system supply than exist today and the exposure to huge take-or-pay and other damage lawsuits by producers.

Given the foregoing inevitable result of massive claims by producers (which the Commission was fully apprised of in the comments filed by many parties, not just pipelines), what are the Commission's stated reasons for refusing to grant take-or-pay relief as a condition for allowing producers to get rid of their unmarketable gas by displacing with transportation arrangements firm sales commitments of those same producers? First, the Commission says that there is a "serious question as to whether the Commission has the authority to require a non-jurisdictional party to give up a valid contractual right as a condition to obtaining service" and states that a "number" of pipeline representatives expressed such a condition was a "close question." (See pp. IV.A.45-46). Perhaps it might be considered a quibble to question whether two pipeline representatives constitutes "a number" of them,[4] but there were at least three such representatives who expressed no doubt at all concerning the Commission's power, including the general counsel of the pipeline trade association, INGAA.[5] Moreover, after the conclusion of the public conference, INGAA filed a supplemental letter (attached as Appendix A to this Application and Petition for Rehearing) on behalf of all of its members which documents beyond question the Commission's power to impose such a condition, but such letter which is a part of the record goes totally unnoticed or at least uncited in the Commission's discussion of this matter.[6] More importantly, the Commission's "legal" discussion of the proposed take-or-pay condition addresses a non-issue, namely, the extent of the Commission's direct authority over producers. Transco and INGAA did not and do not make any claim that the Commission's direct jurisdiction over producers, or lack thereof, is the basis for its power to compel producers to grant take-or-pay relief under existing contracts if they wish to displace the sales that would otherwise be made to pipelines under those contracts. Rather, the basis for this authority is the Commission's conditioning power under Section 7 of the Natural Gas Act, the discussion of which is fully covered in INGAA's supplemental letter (Appendix A hereto) and totally unanswered in the Final Rule.

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[3] Aside from the fact that new gas can be bought today cheaper than the average of many pipelines' embedded gas costs, there is the added feature that conversion from sales to transportation would allow a distributor to escape the minimum commodity bill contained in the sales tariffs of many pipelines (see p. 13, *infra*).

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[4] Transcript, Public Conference, RM85-1-000 (August 1, 1985), pp. 128, 188.

[5] Id. at 131, 139, and 189.

[6] The Commission also cites two documents to support a claim that a "definitive answer" could not be given to the question (at p. IV.A.46 and footnote 46), but a search of these documents discloses that the issue is not even discussed in them.

The second reason given by the Commission for refusing to condition producer access appears to be that take-or-pay is really not a serious problem. The Commission notes that despite the estimate of some $7 to 10 billion of outstanding potential take-or-pay liability, actual prepayments in rate base have been significantly lower. What the Commission fails to realize, or at least note, is that pipelines probably couldn't even fund $7 to $10 billion of prepayment liability and that this situation has led simply to outright refusals to make such payments, which in turn has spawned numerous lawsuits by producers presently pending in the courts.

As further "evidence" that take-or-pay liability is not a serious problem, the Commission states that pipelines have "bought out" over $470 million of liability for about $80 million (or some 16 cents on the dollar)[7] and that negotiations are continuing. The implication seems to be that pipelines have been able to work out of take-or-pay problems in the past and there is no reason to believe that they won't be able to do so in the future. While it is true that some past take-or-pay problems have been resolved through negotiation, it is also true all such negotiations have not been successful. And of course negotiations are continuing because pipelines have no alternative other than being sued. But the most important points are that (1) Transco knows of no widespread industry use of buyouts such as were envisaged by the "safe harbor" proposal that was discarded in the final rule or the Policy Statement of April 10, 1985 herein which has been resurrected and glorified, and (2) the take-or-pay problems which have existed in the past when pipelines have generally been refusing to compete with their own sales are but a drop in the bucket to the take-or-pay problems which would ensue under the Commission's "open access" rule where pipelines are subject to the potential loss of virtually all their sales without any relief under existing producer contracts.

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[7] Sixteen cents on the dollar for $7 to $10 billion of liability would amount to $1.1 to $1.6 billion, amounts hardly to be sneezed at.

Finally, the Commission refuses to grant a take-or-pay relief condition because it wants to provide open access on a non-discriminatory basis to all producers as well as distributors and end-users. What the Commission apparently refuses to recognize is the idea that granting open access at the distributor end of the pipeline — which permits the distributors to abrogate their contracts with pipelines — is totally inconsistent with precluding pipelines from a concomitant modification of their contracts with their producers when the Commission grants "open access" to all producers without requiring take-or-pay relief or contract cancellation. Equally serious, moreover, is the Commission's reliance upon the term "non-discriminatory" to allow producers to supplant their contracted sales to pipelines while in the same breath claiming that it can't require take-or-pay relief because it has no comprehensive jurisdiction over producers. Of course, it doesn't have comprehensive jurisdiction over producers and this is the very reason why the use of the term "non-discriminatory", a term that applies only between pipelines and their customers, 8/ is sheer sophistry.

The stark reality is that the system into which the Commission is attempting to force the pipelines would allow distributors and end-users to obtain their supplies at market-oriented prices while permitting the producers not only to thereby sell directly to distributors and end users those supplies which are presently unmarketable to pipelines through normal channels because of the gas bubble, but also to "sell" to pipelines, through attempted enforcement of take-or-pay clauses, the gas which is presently committed under long-term contracts to pipelines to serve existing

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8/ In this regard, it is well-settled that even back during the period when the Commission had comprehensive jurisdiction over all pipeline-producer contracts, the Commission in no way required pipelines not to differentiate or discriminate among their producers with respect to contract provisions. Indeed, there were numerous divergent provisions in such contracts.

long-term commitments to their customers, but which will be replaced by the new direct sales by producers. The consumer thus wins by obtaining gas at the market-oriented prices which he should be paying, but the big winner is the producer who gets to enforce his existing non-market oriented gas contracts and at the same time to sell directly his otherwise unmarketable surplus gas. And it doesn't take a great deal of perspicacity to determine who the loser is, namely, the pipeline who is told by the Commission that his contracts with his producers are sacrosanct but his certificated contracts with his distributors aren't worth the paper they are written on. It is difficult to conceive of a rule which could be conjured up which would treat the pipeline industry in a more inequitable, arbitrary and capricious manner.

B. The Commission's Option for Distributors to Reduce or Convert to Transportation Up To 25 Percent of Firm Contracts Each Year for Four Years Is Arbitrary and Unsupported By The Record

At the outset, Transco reiterates the position which it took in its Comments on the NOPR (at p. 6), namely, that it desires ultimately to shed its function as a gas merchant and become totally a transporter of gas. In this way the merchant function, which is ultimately to be totally deregulated, can be separated from the transmission and distribution functions which will continue to be regulated at the federal and state levels, respectively. Transco opposes, however, the blunderbuss approach of the Commission which would permit customers to reduce or convert firm contracts by as much as 25 percent per year for four years. This option on the part of the customer, which the Commission in all apparent seriousness terms "voluntary" on the part of the pipeline because it is "accepting" an open transportation program (see p. IV.A.78; see also, p. IV.A.69 where the pipeline "agrees" to the conversion and reduction as a condition to the privilege of competing with its own sales),[9] is totally unsupported on the record. Even conceding that the Commission has broad authority to impose conditions on certificates voluntary sought, there are at least two reasons why that authority does not apply here. First, the certificate must be one which covers a service which the pipeline company seeks to perform. Second, whether the terms "mandatory," "coercive" or "induced" are used to describe the "open access" program, it is clear that this program is not one being volunteered by the pipelines, certainly not on the terms imposed by the Commission. Section 7(e) of the NGA provides that such conditioning power is limited to "such reasonable terms and conditions as the public convenience and necessity may require." 15 U.S.C. § 717f(e); emphasis supplied. The Commission has made no effort to comply with that statutory provision. Most importantly, it has not reconciled the contract conversion/reduction provision with its refusal to condition open transportation on take-or-pay relief. Additionally, it has made no effort to determine the extent to which distributors may wish to exercise such an option, the rate consequences to the pipeline or the pipeline's remaining customers of any such exercise, the resulting impact upon reliability of supply to captive customers, or where the gas is coming from to fulfill the option. We would reiterate that Transco supports a reasonable, even-handed, and properly supported contract conversion/reduction mechanism. However, the contract conversion/reduction option as it has been adopted in the Final Rule is arbitrary, capricious and unsupported on the record.

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[9] Apparently this bit of specious rationalization was considered necessary because of the Commission's refusal to deal with producer-pipeline relationships.

C. The Commission Erred in Adopting a Part of Its Rule Without Considering the Impact of the Block Billing Proposal of the NOPR

The Commission consistently proclaimed that its NOPR was an entire package which would be considered and adopted simultaneously. Transco took the Commission at its word in commenting on the NOPR and, when it appeared that pressure was being brought by the producing industry and certain industrial end-users to drop block billing from the package, filed a supplemental pleading in which it specifically endorsed the consideration of the package as a whole. (See, Transco's responsive pleading filed August 28, 1985 and referred to at page 3 of the Commission's Notice of October 9, 1985 requesting supplemental comments on block billing). Indeed, the Commission had consistently agreed that all parts of the NOPR should be considered together. Transco did not favor block billing in its comments or, for that matter, any open transportation program which would require it to compete with its own sales and permit its producers and distributors to evade their traditional responsibilities to sell and buy gas, respectively, under the long-term contracts which had been freely entered into for that purpose. Transco did, however, assume that block billing would be adopted and consequently made constructive suggestions which would permit all parts of the Final Rule to operate without crippling any segment of the industry.

Now it appears that block billing is in serious jeopardy of not being adopted 10/ or if it is adopted as now proposed, the Commission has gone out of its way, apparently deliberately, to expose the pipelines to liability under contracts covering gas which cannot be marketed because block billing has been mandated. 11/ Either way, the Commission is attempting to place pipelines in the worst of all possible worlds. With continued rolled-in pricing, there are hardly any pipelines which could compete with the spot market prices presently available, which means — for distributors served by those pipelines which accept open access transportation — a

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10/ The basis for this doubt is the Commission's emphasis on the need to focus on the security of long-term supply in the renoticed block billing proposal. Ironically, it was Transco's understanding that the economic justification for deregulation — and a return to free market behavior — is the notion that market-oriented pricing will result in supply/demand equilibrium which will avoid the shortages and surpluses induced by regulatory interference in a market.

11/ Whether, if block billing is adopted, the Commission's words in fact make sequential purchasing voluntary remains to be seen. Transco's comments on the renoticed block billing proposal will address this matter.

wholesale shift from purchasing gas from the pipeline to purchasing gas on the spot market from producers. With block billing, the pipeline can still not compete with spot prices unless he "voluntarily" purchases his gas on a sequential market responsive basis regardless of gas purchase contract terms.[12] In either event, the pipeline is deliberately exposed by the Commission to massive contract claims. Clearly, this squeeze on the pipelines is unlawful.

D. The Commission's Rate Conditions Not Only Are Unlawfully Vague But Also Appear To Be Designed to Penalize Pipelines By Assuring That They Will Not Earn A Fair Return On Their Investment

The Final Rule contains an extensive discussion concerning the rate aspects of the contract conversion and reduction options which are afforded to distributors under the "open access" transportation provisions. One change which was made from the NOPR and which is reasonably clear[13] is that pipelines are allowed to charge a reservation charge not to exceed the amounts collected in the demand charges of its sales rates for new firm transportation. Such a reservation charge would obviously apply to conversion options. However, the rate implications of exercising the reduction option are less than clear. At various points, the Commission seems to say that the reservation charge may also be charged to the customer's reduction in contract (see, e.g., p. IV.A.101), which would mean a reservation charge for no service. At other points, there are discussions concerning the issue of cost shifting due to reduction and conversion options and there are suggestions that (1) there may not be any cost shifting but then again there may be (see, e.g., pp. IV.A.71, 74, 75, 79, 80, 81 and 101), and (2) the pipeline's shareholders may be required to absorb costs related to reductions and conversions to firm transportation (see, e.g., pp. IV.A.35 and 89).

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[12] There is serious doubt in the Commission's mind whether even this method of purchase will allow pipelines to compete with spot gas. See Notice Requesting Supplemental Comments on block billing, pp. 52-53.

[13] Gathering costs, however, are not defined and a number of factors which are required to be reflected in all transportation rates are not specified.

With respect to interruptible transportation service, there is a provision requiring maximum rates and minimum rates on a purely volumetric basis. The maximum rate is presumably cost based, but the costs which may be included in the design of the rate are not spelled out. (See § 284.7(d)(4)(i)). The minimum rate is obviously less than cost based and, because all such transportation quantities are set at the maximum rate in individual rate cases (see § 284.7(c)(3)), such rate appears to be designed to allow a pipeline to cut its losses. The key to whether such downwardly flexible rates would permit the pipeline the reasonable opportunity to earn the fair return on its investment which is assured under the Natural Gas Act and the Constitution 14/ is the manner in which the Commission establishes in individual rate cases the level of transportation quantities upon which the maximum rate is designed. If the Commission were to establish such levels in excess of those reasonably expected to be made *at the maximum rate*, then clearly the rates would be confiscatory and unlawful. There are certainly enough threats in the Final Rule to so conclude (*see, e.g.*, pp. IV.A. 54, 85, 89 and 144), but in the absence of specificity, the Final Rule is clearly too vague to pass muster under the law. 15/

That the Commission's proposed transportation rates appear designed to penalize pipelines is reinforced by the Commission's curious notions as to what constitute the determination of "just and reasonable rates" as reflected in its Notice Requesting Supplemental Comments on block billing (at pp. 16-17). All of the criteria

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14/ *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); *Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679 (1923); *See also*, *State of Missouri, ex rel Southwestern Bell* Tel. Co. v. Public *Service Commission*, 262 U.S. 276 (1923).

15/ It is well-settled that the Commission's orders must provide guidance in the form of rational, intelligible standards for the affected parties. FPC v. Texaco Inc., 417 U.S. 380, 395-96 (1974); *Consumer Federation of America v. FPC*, 515 F.2d 347, 358-59 (D.C.Cir. 1975).

there enumerated relate to a competitive, i.e., unregulated, environment. None of such criteria have any applicability to the Commission's statutory responsibility under the Natural Gas Act to regulate pipelines on the basis of prudently incurred costs, but, when coupled with the maximum rates permitted for transportation, each appears designed to assure that pipelines suffer the consequences of competition without benefitting from the upside potential for increased rewards that true and open competition would permit.

Finally, the transportation rate regulations in the Final Rule are unlawful because they do not carry into the rates for firm transportation conversion the minimum commodity bills which presently exist in the sales tariffs of many pipelines, thus constituting a de facto elimination of minimum commodity bills to the extent the conversion option is exercised by distributors. No foundation for such an action has been established on the record of this proceeding and no findings could possibly be made on this record which would support this additional exposure to loss which is being foisted on the pipeline industry.

E. The Commission's Decision Not To Promulgate Part B Regarding Take-Or-Pay Buyouts Is Justified; The Earlier Statement Of Policy, However, Is Not An Adequate Resolution of Take-Or-Pay Problems

Transco supports the Commission's decision to forego the promulgation of Part B of the NOPR, regarding take-or-pay buyouts. As Transco noted in its Comments on the NOPR (at pp. 10-14), the buyout procedure was unworkable and would not have accomplished the Commission's stated goals. In lieu of the promulgation of Part B, however, the Commission intends to rely on its April 10, 1985 Statement of Policy, 50 Fed. Reg. 16,076. Transco believes that the Statement of Policy suffers essentially the same infirmities as Part B but in some respects (i.e., the absence of any presumption of prudence) is even a step backwards; accordingly, it is a wholly unsatisfactory response to the take-or-pay problems faced by the industry.

Although Transco has been successful in negotiating significant past take-or-pay relief, 16/ substantial exposure to take-or-pay claims remains, both for past periods as well as future periods during which Transco believes it will be unable to purchase all of the gas tendered to it by producers even in the absence of the open access transportation provision. If pipelines opt for the latter, the problem is seriously aggravated and extended. The pipeline's markets are thereby subject to further erosion and take-or-pay claims mount exponentially.

The Commission recognized from the comments it received on the NOPR that "virtually all commentators agree that take-or-pay obligations remain a problem for the industry" and that the "safe harbor" proposal was not a means of resolving that problem (see p. IV.B.10). Transco does not believe that the existing Statement of Policy is any better as a solution. While it does permit one-time payments in exchange for waiver or amendment of take-or-pay provisions, the fundamental problem remains of the likely inability to raise the enormous funds which would be required to make such one-time payments, and the adverse effect of the pipeline's cost of service. The magnitude of Transco's potential take-or-pay exposure is such that it is unrealistic to expect that Transco could amass the amounts necessary to buy out a substantial portion of the take-or-pay provisions in its contracts in any manner which the producers would consider adequate. Transco suspects that other pipelines are similarly situated. In this connection, Table C-1 set forth in the Final Rule (at p. IV.B.12) is not representative of the potential take-or-pay exposure faced by interstate pipelines. That table reflects only successful settlements, and the amounts shown therein are relatively small. 17/ It is conceded by the Commission that the pipelines appearing in

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16/ The settlements achieved by Transco generally are not buyouts as such; rather, they have obtained the release and waiver of past take-or-pay claims, not permanent relief from take-or-pay obligations.

17/ There are, of course, significant other concessions given to producers (e.g., increased takes, purchase of new supplies not presently needed) which are not readily quantifiable in monetary terms.

Table C-1 have potential take-or-pay exposure that is far in excess of the amount of past liability which they have been able to settle to date. Indeed, the Commission observed in the Final Rule (at p. II.24) that the interstate pipeline industry has estimated that potential exposure to take-or-pay claims for gas not taken is approximately $7 to 10 billion. The Commission further noted in the Final Rule (at p. IV.B.12) that Columbia Gas Transmission has proposed buyouts to producers totalling some $800 million. It stands to reason that Columbia's potential exposure for past take-or-pay substantially exceeds that amount. Transco has estimated its past take-or-pay exposure to be approximately $500 million as of July 31, 1985, and that by the end of 1985, such potential obligations could approximate several hundred million dollars more, even in the absence of open access transportation. Therefore, the Commission should be under no illusions: the Statement of Policy has not provided — and will not provide — a satisfactory solution to the enormous take-or-pay problem that still exists in the natural gas industry.

Even assuming that Transco and other pipelines could obtain sufficient funds to buy out take-or-pay demands of the magnitude claimed by producers, the Statement of Policy does not provide any assurance that such payments and associated costs could be included in pipelines' rates. Transco believes that those amounts would be properly includable as costs incurred in providing service to its customers, and that the Commission could not justify excluding those costs. However, unlike Part B of the NOPR, the Statement of Policy includes no presumption of prudence as to negotiated take-or-pay payments. In that respect, then, it is even more unsatisfactory than Part B.

The Commission has also closed its eyes to another critical aspect of take-or-pay buyouts even assuming they could be made and recovered in rates — the effects that would be felt in the marketplace. It is evident that take-or-pay buyouts — coupled with market-oriented pricing — necessarily would result in lower prices to producers to offset the cost of the take-or-pay amounts. The Commission has failed to evaluate the likely impacts of such a course of action on, for example, the availability of future gas supplies.

The Commission should not delay any longer. It *must* squarely address the take-or-pay problems confronting the industry. For reasons previously explained (*see* pp. 3-8, *supra*), on rehearing of the Final Rule the Commission should require any producer desiring to take advantage of open access transportation to relinquish all take-or-pay claims against all pipelines to which it sells gas. This would result in a more equitable balancing of markets and supply. Under the Final Rule as presently promulgated, however, the producers would enjoy the best of all possible worlds. They are able to compete directly in the marketplace for sales traditionally made by pipelines from reserves dedicated by those very producers under long-term contracts, and to displace those purchases and sales. At the same time, the producers retain their take-or-pay claims against pipelines who are unable to market the long-term gas in this new environment. The pipeline is caught in the middle and must contend with loss of sales markets and increased take-or-pay and other damage exposure. As discussed *supra* at p. 5, the Commission unquestionably has the authority to condition a producer's access to open transportation upon a release of take-or-pay claims, and such action is an essential step toward solving the industry's take-or-pay problems.

The Commission could -- indeed, should -- also significantly reduce pipelines' potential take-or-pay exposure by promptly addressing the question of whether take-or-pay payments for gas that will not be made-up by the pipeline, or otherwise recouped, result in violations of Section 504(b) of the NGPA where the gas is or has been regulated as to price under the NGPA. 18/ The issue is pending in a number of

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18/ In the Policy Statement, the Commission announced that buyouts do not violate Section 504(a) of the NGPA (*mimeo* at 3); the Commission, however, expressly stated that the Policy Statement "does not speak to [the nonrecoupable take-or-pay] issue" (*mimeo* at 7) which Transco is again raising here in the hope that the Commission will belatedly take some action.

proceedings. As noted, the Commission reserved this question for future decision in its April 10, 1985 Policy Statement. The Commission should end any uncertainty and hold that nonrecoupable take-or-pay payments of price-regulated gas would violate the NGPA. 19/

While the Commission's goal of restructuring the industry to improve market signals and better balance supply and demand is a laudable one, there simply is no rational justification to exclude producers' gas purchase agreements from that restructuring process. However, neither the Statement of Policy nor the absence of a block billing rule on a contemporaneous basis gives the necessary impetus for producers to renegotiate their contracts.

In summary, the Final Rule in its present form changes only half of the equation. It allows customers of pipelines who elect to provide open access transportation to play the spot market in lieu of their existing purchase contracts and to reduce and ultimately eliminate their firm contractual entitlements, but gives no relief to the pipelines under corresponding contracts with producers. The Commission has the authority to remedy that situation and must exercise that authority to provide the fair treatment to all segments of the industry. In the absence of an effective remedy, the Final Rule is arbitrary, capricious and otherwise unlawful.

F. The Commission Should Proceed With Caution With Respect To Expedition Of Producer Abandonment Applications; Moreover, The New Procedures Appear To Represent An Effort To Coerce "Least Cost" Purchasing Patterns

The Final Rule modifies the Commission's policies regarding producer abandonments to provide that abandonment will be reviewed on an expedited case-by-case basis and will be granted where permitted by the public convenience and

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19/ Transco has discussed this issue more fully in its "Complaint and Petition for Declaratory Order" in Transcontinental Gas Pipe Line Corporation v. Koch Industries, Inc., pending in Docket No. GP84-57-000, and in two similar complaint proceedings involving other producers.

necessity in cases where (1) the producer is subject to substantially reduced takes without payment; or (2) the parties have entered into a take-or-pay buyout. While these new policies ostensibly relate only to procedures rather than the merits, they may signal an impermissible "tilt" toward easing the statutory criteria for abandonment; in any event, Transco urges the Commission to exercise caution in cases where abandonment of low cost gas supplies is sought, without the consent of the pipeline, simply because takes from the producer have been reduced. The Commission should examine the facts on a case-by-case basis, and should not apply a presumption that abandonment is warranted simply because takes from the producer have been reduced.

Also of serious concern to Transco is the apparent coercive effect of the Commission's procedural rules, that is, a pipeline which does not purchase on a strict "least cost" basis is subject to losing a portion of its less costly supplies. This coercion further exacerbates take-or-pay exposure under the higher priced contracts, and thus simply compounds, rather than helps to resolve, the problem.

G. The Optional Expedited Certificate Procedure Apparently Fails To Provide The Necessary Incentives

The remaining part (Part C) of the Order No. 436 package, such as it now is, encompasses the optional certificate procedure which is designed to provide incentives for ease of entry and exit for new or expanded markets, while at the same time holding the parties providing such services "accountable" by putting them at risk for their decisions to respond to the new market opportunities presented by the flexible certification procedures. As Transco stated in its Comments on the NOPR (at p. 14), however, this new certificate procedure "is commendable in concept and intent, but as a practical matter there are serious shortcomings which the Commission should consider and rectify in promulgating any final rule." Transco is concerned that, in the Final Rule, the Commission apparently has not adequately rectified these shortcomings. Although the Commission in Order No. 436 did respond in part to one of the deficiencies noted by Transco and many other commentors by providing for a reservation charge for firm transportation service, as limited as that reservation charge may be, 20/ it apparently has stopped short of making the basic changes necessary to formulate an even-handed 21/ and workable optional certificate procedure with proper incentives.

There appears to be a conflict between the Commission's stated intentions and how the proposed optional certificate procedure actually would operate, as Transco understands it. The Commission's premise is that greater exposure to free market risks will act as an incentive for the pipelines to make better, more rational business decisions insofar as design and construction of new facilities is concerned. Despite its laudable objectives, however, the Commission's proposal does not appear to provide the true incentives which would exist in a free market environment. In that regard, the Commission has not clearly and unequivocally made provision for increased earnings potential for those pipelines willing to take on added risks. However, if Transco simply has failed to understand or appreciate what the Commission's intended incentives are, then the Commission should clarify its Final Rule in this respect.

Insofar as the rate provisions under the optional certificate procedure are concerned, the Final Rule retains most of the parallel rate provisions applicable to the

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20/ Additionally, the Commission has not provided a comparable reservation charge for firm sales under the optional procedure. While the Commission attempted to rationalize this difference in treatment, there would not appear to be any supportable basis for such difference.

21/ In this regard, while the Commission in the Final Rule quite properly rejected certain LDCs' arguments that pipelines should be precluded from "by-passing" the LDCs to render service to end-users (because LDCs in turn were being given contract reduction and conversion rights and otherwise would, in the Commission's words, "have the best of both worlds" (at p. IV.C.9)), this apparent effort "to ensure that participants in the market all compete on an equal footing" (Id.) is illusory. This is so because the LDCs' contract reduction and conversion options would be automatic, but the pipeline's ability to render new or expanded service to end users is subject to protest and hearing procedures and, therefore, is far from being a certainty. Therefore, this procedure does not put all competitors on an "equal footing."

Part A "open access" transportation rules. As such, the Final Rule raises many of the same concerns and apparently suffers the same infirmities as discussed hereinabove with respect to the rate conditions for open access transportation. Suffice it to enumerate here the following points:

- the provision for volumetric rates for firm sales services appears to be designed to discourage new sales services; this is so because the pipeline will not have adequate incentive to undertake the risk of purchasing supplies and allocating capacity to a new sales customer without at least (1) some form of revenue assurance, and (2) an opportunity for upside profit potential;

- the provision for a reservation charge for firm transportation service is, as explained above in connection with "open access" transportation, a less than adequate charge for the recovery of the fixed costs associated with such service;

- the use of "representative volumes" which cannot be decreased (but may be increased 22/), coupled with the mandatory open access transportation feature, 23/ apparently would result in the pipeline's inability to earn even a regulated rate of return on investment; 24/ and

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22/ In that regard, it is unclear whether the Commission intends that representative volumes used to establish rates be increased *only* at the behest of the pipeline which chose to go forward in reliance on the optional certificate. If so, an increase in representative volumes would appear unnecessary in the context of "downwardly flexible" rates. If not, however, the provision creates additional exposure to the regulatory risk.

23/ It also is unclear whether "open access" is required only where transportation service is offered (as provided by Section 157.102(c), or whether it is required also where sales service is offered (as suggested by the text at p. IV.C.16 of the text (*but see* p. IV.C.23 of the text). In either event, the Commission has failed to explain, much less justify, why "open access" is a necessary or desirable additional burden on an applicant for an optional certificate.

An additional element of uncertainty has been created by the lack of definitive pre-granted abandonment authority. In the Final Rule, the Commission has added, in Section 157.106(b)(2), a provision making it difficult to abandon service at contract termination to any new service customer which has not arranged for alternate service.

24/ *See* cases cited in fn. 12, *supra*.

- the limitations on revenue assurances cannot be reconciled with a free-market approach in which the parties would otherwise be free to negotiate a deal which struck a balance that included meaningful revenue assurances.

For the foregoing reasons, Transco requests the Commission to clarify what it perceives the incentives to be with respect to the optional expedited certificate procedure and, in that regard, to reconsider those rate limitations or conditions which may impede such incentives.

IV.

CONCLUSION

For all of the foregoing reasons, Transco respectfully submits that the Commission should grant rehearing of Order No. 436 and, upon rehearing, adopt the changes to the Order proposed herein.

Respectfully submitted,

TRANSCONTINENTAL GAS PIPE LINE
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EXHIBIT C

October 23, 1985

To Producer-Suppliers of
Transcontinental Gas Pipe Line
Corporation and Transco Gas Supply Company

On November 1, 1984, Transcontinental Gas Pipe Line Corporation and Transco Gas Supply Company (collectively "Transco") instituted the Market Maintenance Plan (MMP). That program was designed, generally, to contain Transco's gas purchase costs and to provide market responsive contract pricing adjustments for a twelve month period. A substantial majority of Transco's producer-suppliers agreed to participate in Transco's program and, assisted by that spirit of cooperation and understanding, Transco's gas costs have remained relatively stable. Stable gas costs, however, have not been enough to forestall further significant market loss on the Transco system. This is due to intense competition from alternative fuels and other gas suppliers, as well as a general decline in market demand resulting from, among other events, weather conditions which continue to be unseasonably moderate and state and federal regulatory actions beyond Transco's control.

The existing MMP agreements between Transco and its participating producer-suppliers are scheduled to expire on October 31, 1985. The purpose of this letter is to update you on the current supply and market situation on Transco's system and to set forth the interim steps that Transco believes are necessary in a time of great uncertainty in the natural gas industry.

CURRENT AND PROJECTED MARKET SITUATION

Transco has notified you by previous communications, including a letter dated July 25, 1985, of the critical operating conditions currently existing on its system. The occurrence of various events has resulted in a rapid and continuing deterioration in market demand for Transco's system supply to levels lower than previously anticipated. Consequently, Transco's sales in the market area have been far less than the gas quantities taken from its producer-suppliers in the production area. For a time, Transco was able to maintain the production levels of its producer-suppliers above market demand by utilizing available storage capacity. Transco no longer has storage capacity available to offset the continuing decline in demand and has been forced to reduce its nominations from the production area, such reduction being achieved in part by a suspension of purchases under its Market Retention Program (MRP) beginning in early July, 1985 and reduced purchases under the MMP.

Transco anticipated that its current level of purchases would, by the end of the 1985-1986 winter period, alleviate the operational problems caused by the abnormally high level of gas in storage or destined for delivery to Transco to remedy transportation imbalances. Unfortunately, due to the factors generally described above, nominations by Transco's customers have been at rates significantly below that required to sustain our current level of purchase nominations from our producer-suppliers. As a result, the operational problems on Transco's system have not abated.

In addition, on May 30, 1985, the Federal Energy Regulatory Commission (FERC) issued a Notice of Proposed Rulemaking in Docket No. RM85-1-000 (NOPR). This proposed rulemaking envisioned a fundamental restructuring of the entire natural gas industry, including open access to transportation services on a nondiscriminatory basis, the abolition of rolled-in pricing and the implementation of a block billing procedure. Unfortunately, Order No. 436 (the "Order") issued by the FERC on October 9, 1985 not only does not implement the FERC's previous plan to address industry problems as a whole, the Order also refuses to deal meaningfully with the take-or-pay problem, which is the most significant and pervasive problem facing the gas industry.

Based on Transco's evaluation of the impact of the Order on its business, Transco believes that if it were voluntarily to adopt open access transportation, its customers would replace their purchases of Transco's system gas with lower priced gas purchased from others as permitted by the Order. This would result in Transco having to reduce even further its gas purchases from producers.

Transco has, therefore, determined that it will not elect at this time to provide open access transportation. Thus, effective November 1, 1985, Transco's authority to transport gas sold in the spot market on a self-implementing basis will terminate except to the extent that such transportation arrangements meet certain criteria contained in the Order. Transco believes, however, that it will have the authority to continue to transport substantial volumes to its primary market area (eleven southeast and Atlantic Seaboard states), as well as other areas, until the earlier of the expiration of various transportation contracts or October 31, 1987. Transco's ability to continue transportation of spot market gas beyond the expiration of its agreements will depend upon its ability to obtain authorizations from the FERC on a case by case basis.

As the industry evaluates the impact of the Order and its implications for the future, the uncertainty caused by the FERC's actions has affected the gas purchasing practices of Transco's resale customers. This uncertainty has also hindered Transco's ability to develop a strategy to address the current problems facing it and its producer-suppliers in the marketplace.

Finally, and notwithstanding the efforts of Transco and a majority of its producer-suppliers to renegotiate contract prices, the cost of gas reflected in two recent purchased gas adjustment (PGA) filings by Transco has been challenged by certain of Transco's customers and consumer representatives, resulting in the issue of Transco's purchasing practices being set for hearing before the FERC. Among the allegations made in that proceeding is the claim by the Public Advocate of New Jersey that prices in excess of $3.40 per MMBtu established under Transco's gas purchase contracts containing "FERC-out" provisions constitute an "abuse" under the NGPA. The Public Advocate is therefore seeking to have the FERC deny Transco the ability to recover in its PGA, and the ability of Transco's producer-suppliers to collect any amounts paid in excess of $3.40 per MMBtu, under those contracts. Although Transco believes that its purchasing practices are, and have been, prudent, the continuing challenges to the gas costs reflected in its PGA filings represent a perception on the part of consumers that gas costs are still too high.

Confronted with the continuing operational emergency on the Transco system and gas costs that, although currently stable, are above market clearing levels in a deteriorating market environment, Transco and its producer-suppliers must continue to work together to respond to the serious marketing problems we face.

TRANSCO'S PLAN OF ACTION

Given the unpredictable course of future events in the natural gas industry, Transco has developed an interim plan of action which we hope will enable Transco and its producer-suppliers to preserve to some extent the natural gas markets on the Transco system until the current uncertainty subsides. The specific actions that Transco intends to take, described more fully below, include 1) an extension of the MMP, with certain modifications, on a month to month basis, 2) the further exercise of market-out provisions in its gas purchase contracts, and 3) the release of excess gas deliverability for sale in the spot market.

1. Extension of the MMP

The existing agreements implementing the MMP are scheduled to expire on October 31, 1985. Although the MMP has not brought Transco's cost of gas completely in line with current market conditions, it has served to contain any increase in gas costs which would have fostered even greater market loss than has been experienced to date. The benefits accruing to Transco and its producer-suppliers through the operation of the MMP warrant an extension of that program on an interim month to month basis. Based upon our experience under the MMP, however, Transco believes that certain modifications to the program are necessary.

First, the MMP agreements establish a price "floor" applicable to market-out clauses contained in Transco's gas purchase contracts with MMP producer-suppliers through October 31, 1985. The existence of this price "floor" has hindered Transco's ability to adjust prices under the market-out gas purchase contracts in response to changing market conditions. In order to enable Transco to react to competitive pressures to the fullest extent possible, the market-out price "floor" contained in the MMP agreement will not be extended. Therefore, effective November 1, 1985, Section 2.(f) (of the September 5, 1984 MMP letter) and 2.(e) (of the October 4, 1984 MMP letter) will be deleted.

Second, Section 3 of the MMP agreements sets forth Transco's priorities for the daily level of gas volumes it will purchase from each of its producer-suppliers under all of Transco's gas purchase contracts. Second priority has been given to gas volumes delivered into Transco's Market Retention Program (MRP). As a result of the serious operational conditions existing on Transco's system, Transco has suspended purchases of volumes under its current MRP beginning in July, 1985. At this time, Transco does not foresee that market conditions will allow it to establish a new MRP beginning November 1, 1985. However, if a change in market conditions does occur that permits Transco to resume the purchase of gas under a MRP, you will be promptly notified.

Third, the Fuel Oil Index of the MMP agreement will be modified to reflect that the base period will remain the period from November 1, 1983 through October 31, 1984.

With respect to the level of discretionary takes under the extended MMP, Transco does not expect that its discretionary takes will increase above the current level established for MMP producer-suppliers (five percent (5%) of current estimated contract deliverability). We will promptly notify you if and when any changes in these relative production levels are possible in light of developments in the marketplace.

Transco's ability to continue its current level of discretionary and protected takes from non-MMP producer-suppliers will depend upon the continued success of the MMP and market conditions.

2. Exercise of Market-Out Provisions

Transco is in the process of notifying its producer-suppliers under gas purchase contracts containing market-out provisions of its exercise of those provisions effective November 1, 1985. A market-out price of $2.15 per MMBtu has been established which reflects the value of natural gas under current competitive market conditions. While we will monitor market prices each month to determine whether an upward or downward change in the market-out price level is warranted due to changes in market conditions, Transco will not exercise its rights under the market-out provisions to establish a market-out price level that is less than $2.15 per MMBtu during the period November 1, 1985 through February 28, 1986, notwithstanding any downward trend in market prices during that period.

3. Additional Actions

In the past, Transco has been willing to cooperate with its producer-suppliers in arranging alternative markets for gas deliverability committed under its gas purchase contracts in excess of Transco's requirements for system supply. This has been accomplished through the release of such excess deliverability by Transco and, to the extent permitted, the transportation by Transco, on a self-implementing basis, of such released gas to points on the Transco system. Although Transco intends to continue to try to accommodate its producer-suppliers in the release and transportation of gas, Transco's ability to do so is limited, as described above, by the regulations contained in the Order.

Transco is hopeful that through corrective action on rehearing of the Order, the FERC will enable Transco to move aggressively into the transportation function. Having been in the forefront of the movement toward increasing the transportation function, Transco desires to continue in that direction when enabled to do so by the FERC.

During this period of market difficulty, Transco will allocate the reduced level of demand among its producer-suppliers in a manner that is as fair and reasonable as possible. This includes monitoring the prices and volumes of protected gas purchase priorities to ensure that such protection, and the level of protection, is clearly warranted by the particular facts and circumstances. In addition, Transco is also taking measures to further reduce or suspend the delivery of volumes covered by any gas purchase contract that has either been terminated or has expired.

The entire natural gas industry has been confronted for the past several years with a myriad of rapid and serious changes. However, most segments of the industry have demonstrated their ability to respond to change in a manner that recognizes and accommodates the interests of all parties to the maximum extent possible. The future of the natural gas industry promises to be no less uncertain, and will continue to require the cooperation of all involved. Transco in particular greatly appreciates the willingness of its producer-suppliers to work with us during these difficult times.

Attached to this letter is a form of amendment to the MMP letter agreement which sets forth the specific terms of the modifications necessary under the extended MMP. We hope that all of our producer-suppliers currently participating in the MMP will recognize the need to continue the program on an interim basis, and will agree to the modification and extension of the program by executing the attached amendment and returning it to Transco. In the event that a Transco producer-supplier has not previously elected to participate in the MMP, such producer-supplier's execution of the attached amendment shall evidence its election to participate in the MMP, effective November 1, 1985, under the terms and conditions of the extended and modified MMP.

Very truly yours,

TRANSCONTINENTAL GAS PIPE LINE
CORPORATION and TRANSCO GAS SUPPLY
COMPANY

David F. Mackie

David F. Mackie
Senior Vice President - Gas Supply
& Marketing

If you have any questions, please contact one of the following at Transco:

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October 23, 1985

To Producer-Suppliers
of Transcontinental Gas Pipe
Line Corporation and Transco
Gas Supply Company

Re: Extension of the Market Maintenance Plan (MMP)

Gentlemen:

Reference is made to the agreement between Transcontinental Gas Pipe Line Corporation, Transco Gas Supply Company (hereinafter referred to collectively as "Transco") and the undersigned producer-supplier of Transco (hereinafter referred to as "Seller") implementing the terms and conditions of the MMP (the "MMP agreement").

The purpose of this letter is to set forth the agreement of Transco and Seller to extend the term of the MMP agreement and to set forth certain modifications to the terms and conditions thereof. Therefore, Seller's execution of this letter shall evidence the agreement between the parties to extend the MMP and to amend and modify the MMP agreement as follows:

1. Transco and Seller hereby agree to extend the term of the MMP agreement, as amended and modified below, on a month to month basis effective November 1, 1985, subject to termination by Transco or Seller on the first day of the month following the date of receipt of written notice of such termination.

2. Transco and Seller agree that Paragraph 2(e) or 2(f), as applicable, of Section 2, "MMP Pricing Terms", of the MMP agreement is hereby deleted in its entirety effective November 1, 1985.

3. Transco and Seller agree that Paragraph 1(d) of Section 1, "Definitions," of the MMP agreement is hereby deleted in its entirety and the following Paragraph 1(d) is inserted in lieu thereof:

"(d) the "Fuel Oil Index" shall be a fraction, the numerator of which is the Fuel Oil Quotiant for the calendar month for which the Fuel Oil Index is being calculated and the denominator of which is .9892 (which is the Fuel Oil Quotient for October 1984 as calculated under the prior MMP agreement). The "Fuel Oil Quotient" shall be a fraction, the numerator of which is the sum of the No. 2 Fuel Oil Price per MMBtu for a calendar month and the No. 6 Fuel Oil Price per MMBtu for a calendar month and the denominator of which is the sum of the No. 2 Fuel Oil Price per MMBtu for the same calendar month two years ago and the No. 6 Fuel Oil Price per MMBtu for the same calendar month two years ago. The Fuel Oil Quotient to be used in the numerator of the Fuel Oil Index shall be calculated each calendar month during the term of the MMP based upon No. 2 Fuel Oil and No. 6 Fuel Oil postings and data for that calendar month and as specified in (e) and (f) below."

4. In the event that Seller has not previously elected to participate in the MMP, Seller's execution of this agreement shall evidence Seller's election and agreement to participate in the MMP under the terms and conditions set forth in Transco's September 5, 1984 MMP letter, as herein modified and amended, effective November 1, 1985.

Except as modified by this agreement, the terms and conditions of the MMP, as set forth in the MMP agreement, shall continue in full force and effect.

Please indicate your agreement to extend, amend and modify the MMP agreement in the manner set forth above by executing one (1) copy of this letter agreement and returning it to Transco no later than December 1, 1985. Should you have any questions concerning this letter, please contact one of Transco's Gas Supply Representatives.

Very truly yours,

TRANSCONTINENTAL GAS PIPE LINE
CORPORATION and TRANSCO GAS SUPPLY
COMPANY

David F Mackie

David F. Mackie
Senior Vice President - Gas Supply
& Marketing

ACCEPTED AND AGREED to this
___ day of _____________, 1985.

____
(Print or Type Name of Producer-Supplier)

By_______________________________

Title_____________________________

Transcontinental Gas
Pipe Line Corporation
A Subsidiary of Transco Energy Company

2800 Post Oak Boulevard
P. O. Box 1396
Houston, Texas 77251
713-439-2369

John J. Esslinger
Vice President - Marketing

EXHIBIT D

October 30, 1985

To Customers of Transcontinental
Gas Pipe Line Corporation

Gentlemen:

On October 9, 1985, the Federal Energy Regulatory Commission (Commission) issued Order No. 436 in Docket No. RM85-1-000 which adopted numerous major changes in its regulations. This Order, if upheld on appeal, will significantly affect the transportation and marketing of natural gas by those entities subject to the Commission's jurisdiction. The purpose of this letter is not to address the many implications of the Order or its deficiencies, but rather to notify each customer of the manner in which Transcontinental Gas Pipe Line Corporation (Transco) will operate commencing November 1, 1985.

Order No. 436 requires each pipeline subject to the Commission's jurisdiction to make an election as to whether it will become an "open access" transporter after October 31, 1985. In view of the many deficiencies of the Order, primarily the failure of the Order to adequately address the serious take-or-pay problem, Transco has determined that it will elect not to become an "open access" transporter at this time.

Consequently, pursuant to the Order many transportation arrangements for "spot gas" must cease after October 31, 1985. To the extent that certain transportation arrangements were authorized and in service on or before October 9, 1985, the Order, as clarified by the Commission on October 24, 1985, does provide for some transitional "grandfathering". Transco has completed its review of all existing transportation arrangements and is in the process of notifying its customers which agreements must cease after October 31, 1985 and which agreements are "grandfathered". In that regard, please be advised that all sales and transportation arrangements under the Transco Resources Program (substitute for the Rate Schedule DS program) will terminate October 31, 1985.

With respect to the criteria governing qualification for interruptible transportation of "spot" gas supplies under arrangements continuing beyond October 31, 1985, Transco's general policy is to require that such transportation service be for loads or markets that would not otherwise be served by gas available under Transco's firm sales rate schedules. In an effort to provide as much specificity as is presently possible, attached is a statement of guidelines and qualifications. Qualification must be re-established under all "grandfathered" arrangements in accordance with the criteria outlined on the attachment for such interruptible transportation to continue beyond October 31, 1985.

For transportation agreements not "grandfathered" under the Commission's Order, Transco is reviewing such arrangements on a case-by-case basis to determine whether markets qualifying for interruptible transportation service under Transco's policy could be served under new transportation agreements. If eligible markets could be served under new transportation arrangements, Transco will seek, with the agreement of the customer, a Section 7 certificate under the NGA to perform such transportation service under terms acceptable to Transco.

Transco is continuing its efforts to contain gas costs and renegotiate problem contracts with its producer-suppliers. Attached is a letter dated October 23, 1985 to Transco's producer-suppliers describing the actions it intends to take to manage its gas costs effective November 1, 1985. These actions include the further exercise of market-out provisions to a price of $2.15 per MMBtu and an extension of Transco's Market Maintenance Plan, with certain modifications, on a month to month basis. As always, Transco will keep its customers abreast of these efforts.

Although Transco has elected not to become an "open access" pipeline at this time, Transco intends to continue to work aggressively with its customers and producer-suppliers to restructure existing contracts. Transco will pursue the regulatory authority necessary to ultimately cease performing the merchant function of buying and reselling gas so as to engage primarily in transportation, storage and other related services, with gas sales being made by non-jurisdictional entities. Transco is hopeful that through corrective action on rehearing of the Order, the Commission will enable Transco to move aggressively into the transportation function. Having been in the forefront of the movement toward increasing the transportation function, Transco desires to continue in that direction when reasonably enabled to do so by the Commission.

Should you have any questions regarding this letter or the attachments, do not hesitate to contact us.

Sincerely,

John Eslinger

JJE/jb

Attachments

"SPOT" TRANSPORTATION POLICY

I. General Policy Statement

Interruptible transportation of "spot" gas will be provided by Transco for loads or markets that would not otherwise be served by gas available under Transco's firm sales rate schedules in accordance with the eligibility criteria set forth in either paragraph A or B below. Each customer will make an irrevocable election in writing as to whether it will seek eligibility for interruptible transportation of "spot" gas under the Daily Threshold Purchase Eligibility criteria set forth in paragraph A below or, alternatively, the Specific Market Affidavit Eligibility criteria set forth in paragraph B below, for the five month period commencing November 1, 1985.

A. Daily Threshold Purchase Eligibility

Each customer electing to seek eligibility for interruptible transportation of "spot" gas in accordance with the standards of this paragraph A, will be entitled to request and receive interruptible transportation service for "spot" gas quantities to be delivered each day above a daily threshold purchase requirement set each month under that customer's firm rate schedule with Transco equal to the average daily quantity purchased by such customer under the firm rate schedule for the same month in the preceding year. The threshold purchase quantity will be adjusted each month beginning December 1, 1985 by a factor to be established by Transco on the basis of the percentage difference between the average degree days recorded in the relevant market area for the previous month and the average degree days recorded for the same month of the preceding year. All requests for interruptible "spot" transportation under the standards of this paragraph A must be made in writing to Transco's Marketing Department.

B. Specific Market Affidavit Eligibility

Each customer electing to seek eligibility for interruptible transportation of "spot" gas in accordance with the standards of this paragraph B, will be entitled to request and receive interruptible transportation service for "spot" gas once a customer purchases, on a daily basis, its firm rate schedule contract quantity from Transco. For interruptible transportation of "spot" gas within a customer's firm rate schedule contract quantity, Transco will perform such transportation service to the extent that the loads or markets for which "spot" gas is sought would not otherwise be served by gas available under Transco's firm sales rate schedules, in accordance with the criteria set forth under subparagraph 1 (alternate fuel displacement) or 2 (alternate gas supplies displacement) below, and to the extent that the loads or markets could not otherwise be served with "spot" gas transported by Transco above a customer's firm rate schedule contract quantity.

1. Alternate Fuel Displacement

In order to qualify for interruptible transportation service to displace alternate fuels, Transco will require a letter from the customer describing the type of alternate fuel to be displaced, the source of such alternate fuel, the actual delivered alternate fuel price per MMBtu available to the identified end user, and the daily gas quantity needed. In addition, Transco's partial requirements customers must indicate in such letter whether the gas cost component of its retail price to the end user is calculated from Transco's firm rate schedule commodity rate or some other cost of gas, and such customers must specify the gas cost component of such retail price in dollars per MMBtu if different than Transco's firm rate schedule commodity rate.

If the actual delivered alternate fuel price per MMBtu available to the end user is less than a threshold price per MMBtu for gas equal to the appropriate Transco firm rate schedule commodity price for the particular zone (or such other gas cost component rate should a partial requirements customer's retail price to the end user be calculated from a cost of gas different than Transco's firm rate schedule commodity rate) times 110%, plus any applicable taxes, then such loads or markets shall be eligible for interruptible transportation of "spot" gas on the basis of alternate fuel displacement.

2. Alternate Gas Supplies Displacement

In order to qualify for interruptible transportation service to displace alternate gas supplies, Transco will require a letter from the customer describing the actual delivered price per MMBtu, the source, and the quantity of the alternate gas supplies actually available.

If the actual delivered price per MMBtu of the alternate gas supplies is less than the appropriate Transco firm rate schedule commodity price for the particular zone, then such customer will be eligible for interruptible transportation of "spot" gas quantities on the basis of alternate gas supplies displacement.

Customers qualifying for interruptible transportation service to displace alternate gas supplies must provide, upon request, data showing the price, quantity and source of alternate gas supplies available to it on a daily basis and the quantity of such alternate supplies actually purchased by it on a daily basis.

3. General Affidavit Eligibility Procedures

All requests for interruptible "spot" transportation under the standards of this paragraph B must be made in writing to Transco's Marketing Department. Any customer requesting interruptible transportation to displace an alternate fuel or alternate gas supplies must provide an affidavit confirming the criteria set forth under subparagraphs 1 or 2 above. Affidavits must be received by Transco's Marketing Department by the first of each month to verify that the subject transportation is serving an incremental load or market. In addition, transportation customers must agree to supply updated data and affidavits upon request to retain eligibility, once established.

II. Minimum Bill Credit

Interruptible transportation deliveries within a customer's firm rate schedule contract demand quantity which the customer certifies as (1) displacing alternate fuels, (2) necessary to serve specific end users, or (3) more economic to such customer (after including all delivered costs and adding thereto the fixed cost component in Transco's minimum commodity bill; e.g., currently 29.5¢ per dt, 30.0¢ per dt, and 31.5¢ per dt in Zones 1, 2 and 3, respectively) than Transco's commodity sales rate in effect at the time of such deliveries, will be considered as having been delivered under the customer's firm rate schedule for purposes of computing the customer's minimum annual commodity bill obligation thereunder.

Senator NICKLES. Mr. O'Neill, thank you very much.

Our next panelist is Hugh Morgan, chairman of the board of Southern Natural Gas from Birmingham.

STATEMENT OF HUGH J. MORGAN, JR., CHAIRMAN OF THE BOARD, SOUTHERN NATURAL GAS CO., BIRMINGHAM, AL

Mr. MORGAN. Thank you, Mr. Chairman, and thank you gentlemen and ladies.

What I would like to do, Mr. Chairman, is just comment on a few things that seem to me to be of significance in keeping in mind the posture, the perspective of a company like ours today when we look at Order 436.

First, as an interstate pipeline company, there is a major duty on us to seek out and obtain long-term gas supplies to meet the certificated service obligations we have with our customers. As the senior officer of my company, this is a responsibility that I feel.

After the 1970's when the whole industry went through acute shortages, we felt it as a company acutely. To meet that obligation, to have gas when our customers call on us for it, we've obtained long-term supplies with take-or-pay provisions in them. Take-or-pay provisions have been part of the natural gas industry since its inception.

The first contracts my company entered into back in 1929 and 1930 had take-or-pay provisions in them. So they're nothing new. But we've got the long-term gas supply to meet the certificated obligations we are supposed to serve. They're certificates of public convenience and necessity covering those obligations we're supposed to serve. Now Order 436 comes down.

It deregulates, or begins to deregulate, to unravel the market end of our system, of our pipeline system. Senator Metzenbaum in his opening remarks referred to the revolutionary changes in marketing, distribution, and sales resulting from Order 436, and I think he put his finger right on it.

Now while that's happening under Order 436, they didn't touch the supply end of the pipeline system where we've got long-term contracts, straitjacket contracts requiring us to take-or-pay for quantities of gas to meet our certificated market needs as we perceive them before this revolutionary change. That's the posture we're in.

Mr. Eck of Amoco on the previous panel referred to take-or-pay as a phony issue. It's not a phony issue to my company. At the end of this year, our take-or-pay obligations will exceed the equity capital of our company by a significant margin. Our take-or-pay exposure will be something like $800 million; the equity capital of Southern Natural Gas Co., is $600 million. By year-end 1986 with rule 436, our take-or-pay exposure will be significantly more than double what it would be at the end of this year. That's not a phony issue. It is the issue and the problem with opinion 436.

Now if I could make two comments regarding to our particular situation.

This year our ability to sell the system gas supplies that we've acquired through the years to meet the certificated obligations we're supposed to sell, our sales of system gas supply will be the lowest they've ever been since I've been with Southern Natural Gas Co., and this is my 25th year.

I have to go back to 1950 to find a year when we sold less gas than we're going to sell this year—into the 1950's. With Order 436, system sales of gas would further decline significantly, aggrevating this take-or-pay problem that I've just described. I hope that kind of puts in magnitude the take-or-pay problem. It is not a phony issue that Hugh Morgan is talking about.

No. 2, with our customers and our end-use consumers in our market area, we've come up with a nondiscriminatory open access transportation program, just as open access as what the FERC is proposing, that we've now filed with the Commission, but that would help us try to handle the take-or-pay problem in some way and at least give us a mechanism for trying to approach it.

That proposal is being supported by every customer on our system, Senator. It's being supported by the end users on our system. But the FERC technical staff has said it will oppose it because opinion 436 preempts the transportation field. Well, if that is the position of the FERC technical staff, I think it's outrageous, and I hope like the dickens that it's not the position of the FERC itself.

Thank you very much much, gentlemen, and ladies.

[The prepared statement of Mr. Morgan follows:]

STATEMENT OF

HUGH J. MORGAN, JR., CHAIRMAN

SOUTHERN NATURAL GAS COMPANY

BEFORE THE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

NOVEMBER 21, 1985

Mr. Chairman and members of the Subcommittee:

My name is Hugh J. Morgan and I am Chairman of the Board of Southern Natural Gas Company and Vice Chairman of its parent company, Sonat Inc. Before I begin my remarks, let me express to you, Mr. Chairman, and to the other members of the Subcommittee, my appreciation for the opportunity to present my company's views on Order No. 436.

Southern Natural Gas Company, an interstate natural gas pipeline company, is the largest supplier of energy to the Southeastern United States. Our 8,800 mile pipeline system transports gas from producing fields to municipalities and distribution companies, which serve residential, commercial and industrial users. We also sell gas directly to industrial customers.

My experience in the industry and with the effects of Order No. 436, Mr. Chairman, is not confined to the interstate pipeline end of the business. I am also Vice Chairman of the Board of Southern Natural's parent company - Sonat Inc. One of Sonat Inc.'s subisidaries is Sonat Exploration, which explores for and produces oil and natural gas in the Gulf of Mexico and onshore United States. Sonat Exploration has ownership interests in nearly 2.5 million gross acres in the onshore United States with considerable involvement in several states including Oklahoma, Texas, Wyoming, and West Virginia.

I believe the Subcommittee is well acquainted with the provisions of Order No. 436 and I will not summarize those provisions here. Instead, my testimony today will address the problems we see with Order No. 436 and the effect it will have on Southern Natural Gas. I also wish to suggest that the Subcommittee consider legislative remedies to address the very serious problems created by the FERC order.

Mr. Chairman, I'd like to take a few minutes to review the current structure of the natural gas industry. The industry has traditionally consisted of three distinct segments:

- Producers, who sell gas at or near the point of production to pipelines;

- Pipelines, both intrastate and interstate, who acquire natural gas from producers near the wellhead and transport it to distributors or directly to large-volume end users. The pipeline has traditionally been responsible for contracting for long-term supplies and providing an adequate and continuous supply of gas to consumers on a long-term basis.

- Distributors, who acquire natural gas from pipelines, are responsible for providing service to the general public, including homes, businesses and industries within their local service areas.

Each class of customers benefits the others, and without this mutually beneficial mix, the interstate pipeline system could never have developed.

Most residential and commercial gas consumers are heavily dependent on natural gas for a significant portion of their energy needs, as they cannot easily switch to alternative fuels. Both pipelines and distributors have had a historic obligation to supply uninterrupted, reliable service to residential and commercial users. On the other hand, industrial customers, who may have a choice of alternate fuels, are just as important to the system as the residential and small commercial customers because they help balance the load between the peaks of winter, when the temperature-sensitive load essentially fills our pipeline to capacity, and the valleys which occur in the hot summer months when there is no heating load. Without the industrial customer, the residential and small commercial customers would be burdened with significantly increased costs.

The interstate pipeline industry has historically been premised on long-term agreements which are required to ensure the reliability of supplies and sales.

The only feasible method of high-volume transportation of gas is by means of a pipeline, which requires enormous capital to construct. The installation of Southern Natural's pipeline network from the 1920s to the early 1970s was extremely expensive and, as you can well imagine, the cost of replacing or duplicating our system today would be prohibitive. Matching long-term supplies with long-term markets is essential to the underlying economies and construction of interstate pipelines.

The contractual arrangements employed within the industry are therefore geared towards long-term arrangements as opposed to short-term commitments. The service obligations between interstate natural gas pipelines and their distributors contain provisions which, in essence, obligate the customers to pay for the reservation of space in the pipeline. The gas purchase contracts between producers and the interstate pipelines also contain some built-in, long-term rigidities. The most troublesome provisions of those contracts at present are the take-or-pay provisions. These provisions require the pipelines to take minimum quantities of gas from the well - sometimes as high as 95 percent of a well's deliverability - or pay for the difference between that fixed amount and the amount actually taken by the pipeline. Unless Southern is able to renegotiate these provisions in our gas supply contracts, our take-or-pay exposure is likely to be nearly $800 million in 1985. In 1986, this figure may rise as high as $1.9 billion. The Commission's Order No. 436 fails to adequately address this severe problem.

Under the terms of the Final Rule, interstate pipeline companies electing to transport under the rule are required to make transportation services available to all persons desiring those services at a rate which would not fully compensate the pipeline for the costs it would incur by rendering the services. A pipeline that accepts Order No. 436 transportation authorization would be required to perform transportation services for its customers even though such services would displace the pipeline's own sales and make it impossible for the pipeline to perform gas purchase contracts with its suppliers. Such contracts were entered into to enable the pipeline to fulfill its obligation to serve its customers' requirements.

The adverse effects of this sales displacement on Southern Natural and its customers would be severe.

Southern already finds itself in difficult operating situation, Mr. Chairman. Because of extremely low sales levels this year, we have been forced to significantly reduce our purchases from nearly all our supply sources. Under Southern's least-cost purchase policy, these reductions have meant that our purchases from higher cost sources have been reduced to only five percent of deliverability, except where we have determined that "take" reductions below certain minimum levels would result in potential damage to the wells or reservoirs in question and create other operating problems. If Southern were to elect to transport gas under the Commission's Final Rule, further reductions in takes from either these or Southern's low cost sources of gas would be required. We believe that further cutbacks of deliveries from our higher cost sources of supply would be exceedingly difficult, if not impossible, to achieve. Therefore, any further reductions would have to be made in our take of low-cost gas, preventing continuation of our least-cost purchase policy and resulting in higher rates to our customers.

In addition, in the month of November Southern enters what is traditionally our storage withdrawal season. During the last three years, storage withdrawals during the winter period have played a critical load balancing role in Southern's system by permitting us to satisfy our customers' high priority heat sensitive requirements in the winter while simultaneously creating storage capacity. This storage can then be utilized the following summer to hold supplies purchased under our gas purchase contracts. If Southern were to elect to transport gas under Order No. 436, our ability to withdraw volumes from storage this winter would be severly limited. In the summer of 1986, then, Southern would be unable to take even the minimum volumes of gas from our suppliers necessary to prevent potential well and reservoir damage and other operating problems.

The physical, operational and contractual structure of Southern's system has developed over nearly fifty years of federal regulation. Given our contracts with producers and distributors, our system capacity, including storage capacity, and the wide swings in sales caused by the heat sensitive requirements of high priority loads, Southern currently finds itself in a position where it is impossible to accept the transportation authorization available under the Commission's Final Rule.

Moreover, in the long term, we feel Order No. 436 will have disastrous results for both Southern and our customers by making it virtually impossible for Southern to provide reliable, long-term natural gas service at a reasonable cost to our customers. Access to transportation which would displace system supply sales, and without a concomitant adjustment in gas purchase contracts entered into in the past to serve our customers' natural gas requirements, would make it impossible for us to purchase the reserves which will be needed to satisfy future sales demands of our customers. The difficulties of meeting those requirements would be compounded by the fact that while Southern would retain the obligation to perform sales service for our customers, those customers would be under no corresponding obligation to purchase from Southern and may, in fact, rely on Southern natural gas for service only during peak periods.

Southern Natural Gas views Order No. 436 as creating impossible barriers in both the short- and long-term, and has declined to accept the transportation authorization available under the rule in its present form.

As in the past, however, and as permitted by the Final Rule, Southern is seeking to effect a transportation program pursuant to Section 7 of the Natural Gas Act to provide for non-discriminatory transportation on fully compensatory terms. Southern has filed an application for such a program in with the FERC Docket No. CP84-342 and settlement discussions are currently underway in that proceeding. We hope for either an interim or permanent settlement which will allow us to implement a broad transportation program on our system. In addition, as in the past, Southern will enter into and process individual arrangements for transportation pursuant to Section 7 of the Natural Gas Act.

Southern believes that the transportation program proposed in Docket No. CP84-342 provides a vehicle for providing transportation services on our system for the next several years while the structure of the gas industry -- created over fifty years of regulation -- is modified on an orderly basis. This will permit the needs of Southern's customers for transportation as well as sales service to be met both now and in the future.

In summary, Southern is in the business of providing its customers with the services they need and we will continue to try to provide those services in the future, whether they be transportation, storage, or gas sales. We must, however, be allowed to provide such services in a manner which is feasible in light of the structure of our existing system, our contractual obligations, and in a manner which does not create impossible future barriers.

Even though Southern is electing not to accept the transportation authorization available under the Commission's Final Rule, we will be able to continue certain of the self-implementing services that we are currently performing for a limited period beyond November 1, 1985, pursuant to the Final Rule's "grandfathering" provisions. With regard to take-or-pay, we have been attempting to negotiate with our producers to settle disputes and revise contracts to reflect more accurately today's market realities. Unfortunately, just as there is little incentive for natural gas pipelines to provide transportation under Order No. 436, there is also little incentive for our producers to negotiate take-or-pay problems due to FERC's failure to address this fundamental issue. We would encourage and applaud any effort by this subcommittee to remove these disincentives.

Let me stress that Southern Natural favors competition in the marketplace. Prior to Order No. 436, voluntary transportation made up approximately 40% of our total natural gas volumes. With approval of our filing in CP84-342-000, Southern will continue to voluntarily transport natural gas for others.

However, unless and until FERC or the Congress addresses the serious take-or-pay problem which will be greatly exacerbated by Order No. 436, we see little prospect for improvement in the natural gas industry. In this regard, Southern Natural supports SR 255 and its concern that the FERC address the take-or-pay issue and other issues which I have discussed with the objective of removing the disincentives for interstate pipelines to participate in Order No. 436.

Thank you again for the opportunity to express our views on what we view as the most serious threat to the pipeline industry since its inception.

Senator Nickles. Mr. Morgan, thank you very much.

Our next panelist is William Terpstra, president and CEO of Midcon Corp., from Illinois.

STATEMENT OF WILLIAM C. TERPSTRA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MIDCON CORP., LOMBARD, IL

Mr. **Terpstra**. Thank you, and good morning.

There are two areas I would like to cover in my comments today. They are, first, why Midcon's pipeline subsidiaries did not accept the voluntary provisions of Order 436; and second, what must be done to Order 436 to make it acceptable.

There are four basic reasons Midcon's pipeline affiliates did not accept Order 436. They are:

First, our supply was procured based on our customers market estimates as given to us. Distribution customers should not now be given the unilateral right to walk away from the consequences of their actions. For example, as agent we advanced $20 million of customer funds to a producer which has resulted in almost 400 bcf of remaining reserves of $4 gas. Clearly we did not get into this problem totally by ourselves and should not bear the entire burden.

Second, the proper handling of take-or-pay costs or renegotiation of nonmarket-responsive contracts is not addressed. Open access will aggrevate these problems. A take-or-pay settlement of only 10 to 15 cents on the dollar for our high cost contracts would erase our entire shareholders equity. The rules must provide for contract sanctity or contract renegotiation at both ends of the pipeline, not just one end.

Third, transportation rules provide more regulation of our system, not less. The proposed rules provide for an inefficient and inflexible use of our pipeline system, not commonsense operations.

Fourth, new entrants into the market; namely, sellers—have have an unfair competitive advantage because they have complete pricing freedom and no supply responsibility. Pipelines will be strongly disadvantaged in the long term by their continuing service obligations, current inflexible contracts, and the regulatory approvals required for price or market changes.

There are many things in Order 436 that must be corrected. We must encourage renegotiation of contracts at both ends, as I have said. On the producer end of the pipeline, this might be achieved by the Commission issuing a rule that those producers with high cost gas contracts who are willing to make them market responsive will be given the opportunity to receive higher prices for the old gas as consideration.

At the market end of the pipeline, equity could be achieved by renegotiation, not abrogation of distributor contracts. Such solutions are necessary to permit contract purchase requirements to match our market requirements. Much remains to be done.

If the FERC is to make a success of their program, they are going to have to alter Order 436 to aid in creating an equitable transition period. Our view of what the Commission has done is stated most eloquently in the following quote from this Monday's Gas Daily: "The pipeline industry's attempt to wield a congressional coalition failed before it got started since pipelines had little to offer other segments of the industry. They came to the table without any cards, a leading producer noted."

The reason is that Order 436 dealt all the cards to the producers and the distributors. We don't have any. We are willing to leave the past. We are willing to let the market decide to what extent they wish us to be a merchant and to what extent they wish us to be a transporter. However, there must be an equitable transition from the past to any new environment. The goal must be to push renegotiation of nonmarket-responsive contracts and conditions at both ends of the pipeline system.

Any proposed solution that does not deal with producer-pipeline contracts, pipeline-distributor contracts, access, and pricing, is not an equitable transition nor a solution.

Thank you.

[The prepared statement of Mr. Terpstra follows:]

STATEMENT OF

WILLIAM C. TERPSTRA

PRESIDENT AND CHIEF OPERATING OFFICER

MIDCON CORP.

Summary of Comments by William C. Terpstra

- Order 436 is not:

  a) a program to make it easier to provide transportation.

  b) deregulation; it is increased pipeline regulation.

  c) an even-handed resolution of the problems of the gas industry.

  d) an equitable transition to a different industry environment.

  e) a complete package as it fails to resolve key issues of take-or-pay or block billing.

- We are troubled by the attempt of FERC to use its rulemaking power to make fundamental structural changes in the industry. We believe this attempt exceeds its legal authority.

- Problems with Order 436:

  a) existing supply responsibility and contractual issues are placed on pipelines for supplies funded by, and developed to serve, their customers.

  b) no new guidance or resolution of take-or-pay are provided by Order No. 436. There must be an equitable transition which addresses the contractual issues arising out of the preexisting regulatory scheme, contractual relationships and industry structure

  c) If we are to have a workable competitive gas industry, pipelines must have equivalent rights with other competitors to price gas, offer discounts and market gas.

  d) Pipelines must retain the ability to control their own operations. "Common-sense" carriage is needed rather than a multitude of new, detailed regulations.

- Block Billing Proposal. The Commission's proposal -

  a) fails to deal with its take-or-pay consequences;

  b) provide interstate pipeline with the flexibility to compete on an equal footing with other sellers;

  c) supply any incentives for producers to renegotiate;

  d) recognize the need for restructuring at the pipeline-producer as well as the pipeline-distributor level, to afford similar treatment to "contract sanctity" or to balance the interests of affected industry segments.

- MidCon supports access to its natural gas transportation system in a manner which will fairly balance the interests of consumers, distributors, producers and transporters of natural gas. Order 436 does not accomplish such a balance.

STATEMENT OF
WILLIAM C. TERPSTRA

I welcome the opportunity to discuss current events in the pipeline segment of the Natural Gas Industry. My name is William C. Terpstra and I am President and Chief Operating Officer of MidCon Corp. MidCon is the parent of a diversified group of energy-related domestic companies. MidCon's subsidiaries operate primarily in the Mid-Continental United States and engage in three principal lines of business: natural gas transmission and marketing; oil and gas exploration and production; and onshore drilling. In the pipeline industry MidCon owns Natural Gas Pipeline Company of America (Natural), Mississippi River Transmission Corporation (MRT) and is in the process of finalizing its acquisition of United Energy Resources which includes United Gas Pipeline and United Texas Transmission Company.

In the brief time allotted to me, I will discuss MidCon's position on Order No. 436 and also on the Commission block billing proposal. I will explain why MidCon has not yet agreed to provide transportation under Order No. 436. I will focus on specific problems and try to avoid the vague generalities which have plagued discussions of the Commission's rule and the concepts of so called "open access" and block billing. Our views are set out more fully in requests for rehearing of Order No. 436 filed November 8 with FERC by our affiliates, Natural and MRT, and in supplemental comments on the block billing proposal filed with FERC by Natural on November 18.

At the outset, I want to emphasize what Order No. 436 is not.

- It is not a program to make it easier to provide transportation.
- It is not deregulation; it is increased pipeline regulation - especially of operations.
- It is not an even-handed resolution of the problems of the gas industry.
- It is not an equitable transition to a different industry environment.
- It is not a complete package at present as it fails to resolve key issues.

Similarly, I would emphasize what block billing does not do.

- It does not put all market participants on an equal footing. Rather, pipelines are placed at a severe competitive disadvantage due to existing supply commitments and more stringent regulatory restrictions on pricing and marketing gas.
- It does not give producers any incentive to renegotiate high cost, high take contracts and does not properly transmit market signals.
- It does not reflect consistent treatment of contract sanctity. The sanctity of producer-pipeline contracts is honored while pipeline-distributor contracts are abrogated.

One of MidCon's subsidiaries, Natural, has already been transporting large volumes of gas under the Commission's best efforts transportation programs--some 225 Bcf in fiscal 1985. This is in addition to nearly 200 Bcf of transportation provided under firm, long term arrangements. These figures may be compared with Natural's annual sales of about 900 Bcf. The immediate impact of Order No. 436 will be to jeopardize best efforts transportation arrangements. The thrust of the Commission's program is to prohibit new transportation on a "self-implementing" basis unless the pipeline is willing to give up virtually all operating flexibility and accept significant, detailed new regulations of its daily operations.

We are troubled by the attempt of FERC to use its conditioning power to make fundamental structural changes in the industry. Seemingly, the industry cannot rely on the language of governing statutes if FERC can ignore Congressional intent and come up with its own scheme.

What I will try to explain today is why it is crucial that pipelines retain their flexibility, particularly since the Commission has chosen not to address all the transitional problems such as pipeline/producer contracts.

Natural has for decades accepted a firm service obligation to its customers. To maintain the supply necessary to meet that obligation, Natural has entered into firm, long-term contracts with producers. Natural's current commodity rate reflecting those contracts is $2.7792 per MMBtu, of which $2.5420 represents gas costs.

This is well under alternative fuel prices. For example, #6 Fuel Oil prices are generally in the $4.50 - $4.75 per MMBtu range. However, short-term spot market gas is currently available to Natural's customers at prices as low as $2.40 - $2.50 delivered to the customer. Approximately 45 Bcf of spot gas entered Natural's market during the 12 months ended September 30, 1985. Moreover, purchases of such supplies are sharply on the upswing. Eight (8) Bcf entered our market in September and sixteen (16) Bcf in October. The suppliers of this spot gas, however, have no firm obligation, no necessity to maintain a supply and they deliver gas "as available." By contrast, our customers expect our pipeline affiliates to stand ready to meet their needs on a few hours notice if spot sources are interrupted. For example, one of Natural's major customers said exactly that, as reported in Inside FERC's Gas Market Report for November 1, 1985. In October, they were buying 75,000 to 100,000 Mcf/day of spot gas from about seven suppliers. According to a company official:

> As winter goes on, we fully expect that we wouldn't get the quantities we're getting now. But we're counting on some deliveries in the winter. We'll fall back on the pipeline suppliers for the full contract volume on the days that we have to. . .

This is illustrated by our experience last winter when temperatures dipped below zero and virtually all spot purchases ceased. Instead, our customers turned to Natural and expected it to meet their full peak requirements. It is very difficult for a pipeline to negotiate for supplies to meet peak needs only. Producers want purchasers which take gas throughout the year, not just on peak days. Thus, the increasing use of Natural as a peaking service aggravates our contract problems.

In light of these conditions there are four (4) key problems with Order No. 436 I wish to discuss:

(1) Supply Responsibility

Order No. 436 places the entire responsibility for existing supply commitments on pipelines. This is neither fair nor appropriate. Our customers have played an integral part in developing those supplies.

Much of Natural's current supply was developed through the FERC approved advance payments program during the 1970's. Of the total program advances of about $555 million our customers funded directly approximately $118 million. These advances resulted in some 1.8 Tcf of reserves, 50% of it NGPA §102 gas now selling above $4.00 per Mcf. The average cost of these reserves is about $2.80 per Mcf today. In fact, of the 1.8 Tcf, 450 Bcf resulted directly from a $20 million advance from our customers to a single producer. If our customers under the proposed block billing procedure are to benefit from low cost block 1 gas, which they did not fund, then they should share pro rata in the higher cost block 2 gas they funded and encouraged us to obtain. The Commission's proposed block billing procedure does not recognize this.

While about 45% of Natural's supply is still low cost NGPA §104 or §109 gas, our supply program has elicited very substantial new reserve commitments since the NGPA was passed. These supplies were procured based on customer needs as they projected them to us annually in writing. We did not get in this situation all by ourselves. Where we are today was a result of decisions by producers and distributors as well as pipelines. We acknowledge that changes are necessary but producers should not be afforded open access or distributors the right to walk away from their contractual commitments with pipelines until we get some resolution, with a sharing by all industry segments, of the problem of high cost gas contracts and take-or-pay.

(2) Take-or-pay.

The Commission in Order No. 436 offers no new guidance or solutions on take-or-pay, despite the implications of increased transportation for aggravating this problem.

The industry has been heavily regulated and structured to provide an assurance of reliable service. The spot market is a relatively new phenomenon. Natural is willing to embrace new goals which include greater price competition. We are willing to be a transporter rather than a merchant. But there must be an equitable transition which addresses the contract issues arising out of the preexisting regulatory scheme, contractual relationships and industry structure.

The impact of Order No. 436 can be illustrated by a few statistics relating to Natural's system. Natural's total equity as of September 30, 1985 was $589 million. Regulated earnings for the 12 months ended September 30, 1985, were $84.5 million. If Natural opens up its system under Order No. 436, Natural estimates it will incur take-or-pay of between $600 million and $1 billion for fiscal 1986. Producers may tell you not to worry about liability of this magnitude, but they are not so flippant when it comes to negotiations with pipelines. If producers are serious that take-or-pay is not a problem, they should be willing to waive take-or-pay in return for open access and the greater marketing opportunities which result. Even if Natural were able to "buy out" this liability at 10-15¢ on the dollar such payments would still more than erase jurisdictional earnings. And that would be only a temporary solution. The same problems would arise in 1987, 1988 and so on. Buying out our total obligation on all reserves of high priced gas, even at 10¢ on the dollar, would erase Natural's equity. Clearly this is a problem which cannot be ignored and which requires a solution which is equitable for all parties.

One solution is for producers to waive take-or-pay in return for open access to our system and the greater marketing opportunities which would result. A second solution is to permit Natural to cut back takes from producers to the extent of transported volumes. A third solution is to permit expedited abandonment of high cost unmarketable gas supplies combined with waiver of contract rights related to such supplies. Finally, a fourth solution would be to permit selected renegotiation of high cost and low cost contracts if both are held by the same producer. We are flexible as to the exact manner of resolution, but any equitable solution must deal with the take-or-pay issue.

(3) Equality for Sellers

Under the NGA, pipelines cannot change their prices, alter margins or seek new markets without seeking specific regulatory approval entailing lengthy delay even in response to new sellers which are taking away their markets. Natural has a margin of about 23¢ in its commodity rate of $2.78. It has lost sale to competitors in recent months of about 500 MMBtu/d because of a price difference of less than 1¢. Since October 1984, we have sought the right to cut our margins, as necessary to retain these sales, but were only able to obtain approval in early November, 1985 and then to be effective only until December 31, 1985. By contrast other sellers (other than interstate pipelines) can change prices daily, discount selectively and pick and choose markets. Spot sellers, unlike interstate pipelines need no facilities, have no firm service obligations and thus need not maintain a firm supply and incur the attendant costs.

If we are to have a workable competitive gas industry, pipelines must have equivalent rights with other competitors to price gas, offer discounts and market gas. Pipelines should be free to purchase spot gas and sell it separately from system supply to whatever customers it can attract. Order No. 436 does not address these concerns but merely expands the competitive advantages of other seller _vis_ _a_ _vis_ interstate pipelines. It is not remotely close to laying the foundation for a viable long-term industry structure.

(4) _Operational Control_

Pipelines must retain the ability to control their own operations. Under Order No. 436 pipelines must essentially provide transportation service to anyone which requests it. This is a naive and simplistic approach promulgated by people who know little of what is entailed in operating a pipeline system.

A prime example of the impracticality of these rules is the "first come, first served" rule for access to pipeline capacity. If a shipper wishes to use and pay for best efforts transportation on 10 miles of a 1000 mile system, there is no basis for refusing access if capacity is available. However, if an 800 mile haul materializes a week later, it would promote gross inefficiency to "bottleneck" the pipeline by precluding that long haul in favor of the 10 mile haul merely because the short haul was earlier in line. There are many additional examples of the operational impracticabilities a pipeline can recite concerning Order 436. The direction of Order No. 436 is more regulation. Natural is perfectly willing to be a "common sense" carrier and have our decisions subjected to scrutiny to assure we are being even-handed. We do not, on the other hand, wish to have decisions made for us through inflexible, arbitrary rules which permit no latitude for proper, efficient operation.

The Commission's block billing proposal raises many of the same issues as Order No. 436. Pipelines wishing to provide any "self implementing" transportation business must, under Order No. 436, throw open its system to all comers, without regard to the impact on a pipeline's markets, gas supply or take-or-pay liability. Under the block pricing structure, pipelines will be prohibited from rolling-in the lower prices of price regulated gas with newer, higher cost supplies. Both programs limit pipeline flexibility and undercut its competitiveness as a seller. However, in both instances, the Commission has failed to:

(a) Deal with the enormous take-or-pay obligation of interstate pipelines which will result;

(b) Strike any sort of balance of interests between pipelines on the one hand and either producers or distributors on the other during the transition period;

(c) Provide any means for pipelines to compete as sellers, on an equal footing, with other market entrants such as producers or brokers; and

(d) Recognize the need for equivalent treatment of contract sanctity at the pipeline--distributor level and at the pipeline-producer level.

The Commission's proposal, together with Order No. 436, will drastically reshape a pipeline's relationship with its customers. Yet the Commission fails to recognize the corresponding need to modify pipeline-producer relations. Natural believes that the following modifications to the Commission's block pricing proposal are imperative if it is to work effectively:

(1) Block 2 should be subdivided into blocks 2(a) and 2(b);

(2) The Commission should mandate a sequence of purchases;

(3) Pipelines should be accorded greater pricing flexibility;

(4) The Commission must address the take-or-pay consequences of its rules.

Take-or-pay has been discussed at some length above. Block billing as currently proposed by the Commission will aggravate that problem. In Natural's case, over 50% of its supplies or 500-600 Bcf annually, would fall into block 2, based on preliminary estimates. This entire block 2 volume, when segregated for pricing as proposed, will bear an average price of about $3.50 per MMBtu, well in excess of that for supplies available today on the spot market. Thus, pipelines will lose markets and experience increasing take-or-pay exposure.

Natural currently has under contract approximately 300-350 Bcf annually of gas not eligible for block 1 which Natural believes is competitively priced under contracts with market responsive provisions. Natural's proposal is to include all gas under all new, renegotiated, and market responsive contracts in block 2(a), to be purchased before other block 2 supplies. Thus, Natural's market responsive gas would be included in block 2(a) and Natural would purchase such gas before block 2(b) gas.

Under Natural's proposed restructuring of block billing, producers would also have incentives to renegotiate contracts to increase takes by moving their supplies out of block 2(b) and into a market sensitive block 2(a). An individual producer would not have to wait until a pipeline renegotiated all its high priced contracts before the producer began receiving the benefits of its renegotiation. Upon renegotiation, his gas would immediately move to block 2(a) where it could be marketed more readily, so that the producer could enjoy increased takes and revenue flow. Producers which are reasonable in the renegotiation process thus receive immediate benefits. By contrast, under the Commission's proposal, a producer agreeing to renegotiate high cost block 2 contracts would not reap increased economic benefit until many other contracts had been renegotiated, which would severely limit individual producer incentive to bargain seriously.

Similarly, the Commission should mandate sequencing of purchases. The obvious intent of a two-block pricing structure is to ensure that low cost, block 1 gas flows to customers which bought gas during the base period. This intent would be thwarted unless the Commission directs that the pipeline purchase all block 1 gas available to be delivered first to interstate pipelines. Much block 1 gas is under multi-vintage contracts and pipelines typically have limited contractual authority to require delivery of block 1 gas first. Moreover, several states have asserted that state ratable take laws limit pipeline flexibility as to the gas it can purchase. Thus a Commission directive on the sequencing of purchases is necessary.

I have previously discussed the firm service obligation of interstate pipelines under tariffs filed with the FERC. This obligation, and the concommitant need to maintain a firm, long-term gas supply, places pipelines at a severe competitive disadvantage vis a vis other sellers, which can change prices as often as they like and switch markets at will. Neither Order No. 436 or the block billing proposal gives pipeline equivalent flexibility but merely expands the competitive advantage of other market entrants.

Finally, while the Commission fosters abrogation of pipeline-distributor contracts in Order No. 436, it enshrines the sanctity of pipeline-producer contracts. It fails to recognize that its drastic restructuring of the industry requires corresponding responses at both ends of the pipeline. Producer-pipeline relationships must change if pipeline-distributor relationships are altered.

In summary, for the interstate pipelines to make the transition so it can operate under the Commission's program, their contract and take-or-pay problems must be addressed. At the very least the rules must provide incentives, in the form of a block 2(a), to foster renegotiation. Pipelines must be granted pricing and marketing flexibility equivalent to other players if they are to compete. Finally, the need for restructuring at both the distributor and the producer ends of the industry must be recognized. Either contract sanctity must be recognized at both ends or at neither.

We have no problem with open access to our natural gas transportation system in a manner which will fairly balance the interest of consumers, distributors, producers and transporters of natural gas. The problems of pipeline/producer contracts, pipeline/distributor contracts, pricing and access are absolutely interrelated. Any proposed resolution and transition must address all of these issues. Neither Order 436 nor the block billing proposal does this. FERC has not shown flexibility in developing a solution to the issues, and we cannot wait for the courts to decide the issues brought before it as each day our take-or-pay continues to increase. So we believe legislation may be the only timely alternative.

Senator NICKLES. Mr. Terpstra, thank you very much.

We have a vote in process right now, so it will be necessary I think for us to run over there. We should be back probably in about 15 minutes, or hopefully less.

[Recess taken.]

Senator NICKLES. I regret the inconvenience. Our next panelist is Mr. Kinnie Smith, vice chairman of American Natural Resources from Detroit.

STATEMENT OF S. KINNIE SMITH, JR., VICE CHAIRMAN, AMERICAN NATURAL RESOURCES CO., DETROIT, MI

Mr. SMITH. Good morning, Mr. Chairman.

As you well know, our company's principal subsidiary, ANR Pipeline Co., serves some 50 distribution companies in nine Middle Western States. We are the principal supplier of gas to the States of Michigan and Wisconsin. We are pleased to have the opportunity to be here today and express our concern over the Commission's rule 436 and proposed block billing.

With respect to block billing, let me just say very briefly that we do agree with the positions that were stated on the first panel. Even though we are a pipeline and seeking lower cost gas at all times, we do see the same destabling influences in the market, and in the long run the effect on gas supply will be severe.

Turning now to the transportation provisions, there simply is no incentive on the part of the pipelines to participate in this new program. In fact, there is indeed a disincentive. While it's a voluntary program, I'm afraid that the Commission has asked us to shoot ourselves and our customers and our stockholders in our respective feet.

There are two principal problems. One is the increase in take-or-pay, as has been discussed earlier. And second, particularly in our case, the very unfair allocation of costs among our customers. As a result, our company has announced that we would offer open access transportation only until December 15, and after that we will not participate in Order 436.

Now if we were to participate, this would force a very unfair allocation of costs among our customers. Fifty percent of our volumes are sold to customers in Michigan, and 50 percent approximately to customers in Wisconsin and other States. The Michigan customers, the large customers, have partial requirements contracts which enable them to market, to seek gas from other sources under the Commission's new program. When they do that, that will reduce our revenues and cause our costs to be uncovered.

Those costs will have to be reallocated to our other customers who cannot take advantage of the program. In other words, in effect our customers in Milwaukee will be subsidizing the customers in Detroit. That's a fairly blunt approach, but in fact that will happen since those costs which will not be covered will in a subsequent rate case be reallocated to those customers who are full requirements' customers and cannot take full advantage of the transportation program.

The failure of the Commission to recognize these problems with Order 436 has led us as a company, and in connection with others in the industry, to seek legislation. This legislation we recognize will have free and open nondiscriminatory transportation provisions. We recognize that we will be obligated to provide transportation services to producers who are seeking markets, to distributors who are seeking lower cost gas, and to end users who are seeking lower cost gas.

However, as an integral part of that legislation, there must be some take-or-pay relief. In the case of our company, in the first full year under the transportation program we could have an increase in our take-or-pay of some $750 million. That would be $150 million of annual cost of service, and some 40 cents a million cubic feet of increased gas costs. That problem simply must be addressed by the legislation.

Second, there must be no unilateral right to reduce contracts at the sales end of our pipeline when we are locked in at the other end. That raises the fair allocation issue that I discussed earlier.

Now we believe, unlike many in the Congress, that a consensus legislation can be put forth. We understand and recall well that that was unable—it was impossible a few years ago. But there have been some fairly significant changes in the last few years.

First of all, the pipeline companies have become voluntarily very large transporters. They're operating their system as both marketers and transporters.

Second, I think we have become somewhat older and wiser about mandatory carriage. While we all opposed it vigorously some years ago, the Maryland People's Counsel case has stated the law of the land, and we recognize that this would have to be a part of any new legislation.

Third, and very importantly at least in the case of our company, we have come to recognize that old gas should be deregulated. We did not have a flyup at the beginning of this year when a large portion of our gas was deregulated. We have excess supplies and deliverability at this time, and we feel that this is an opportune time to go forward with deregulation of old gas.

That concludes my remarks. Thank you.

[The prepared statement of Mr. Smith follows:]

UNITED STATES OF AMERICA
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

Regulation of Natural Gas
Pipelines After Partial
Wellhead Decontrol

STATEMENT OF
S. KINNIE SMITH, JR.
VICE CHAIRMAN
AMERICAN NATURAL RESOURCES COMPANY
UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
NOVEMBER 21, 1985

Mr. Chairman and Members of the Committee:

I am S. Kinnie Smith, Jr., Vice Chairman of American Natural Resources Company. Our wholly-owned interstate pipeline, ANR Pipeline Company, serves some 50 gas utility distribution customers in nine Midwestern states, principally in Michigan and Wisconsin.

We are deeply concerned about the Federal Energy Regulatory Commission's Final Order No. 436, and appreciate this Subcommittee inviting my Company to express its views.

Need For Legislative Action

The Commission has failed in its effort to structure a program of "open access" transportation that will meet the broad public interest test of the Natural Gas Act. We recognize that the current regulatory system needs change to make it more market sensitive. We would favor a FERC initiated transportation program requiring pipelines to provide non-discriminatory transportation service for producers seeking markets and for distribution companies and end-users seeking low cost gas supplies. Unfortunately, the FERC's "voluntary" open access transportation program is unfair to the many consumers who cannot take advantage of it and has few, if any, incentives for pipelines to participate. In fact, there are many disincentives to pipeline participation.

The Commission's rejection of comments filed by our Company and many others that would have cured the problems inherent in its transportation program, has lead our Company to favor action by the Congress to assure both producers and pipeline customers of open access to gas transportation facilities on terms that fairly balance the interests of all parties--consumers, distributors, producers and pipelines and assure that pipelines will participate in the program.

An essential element of any open access transportation program is protection for our existing customers from being forced to assume higher cost burdens as a result of some of our customers shifting to other supply sources through the use of the new transportation services. Also, the program must resolve the problem of potential increases in take-or-pay payments under gas purchase agreements with producers who are cut back as a result of a shift by some of our customers to alternative supply sources.

The Commission has completely failed to resolve the take-or-pay problem even though we and others have suggested that there are ways to solve it, such as by conditioning a producer's right to use the new transportation service on its concurrent release of future take-or-pay obligations.

Finally, the Commission's new Block Billing Proposal creates market rigidities which will prevent or delay gas prices from being responsive to market conditions and further aggravate the pipelines' take-or-pay problems. Again, the Commission rejected workable solutions which would have encouraged renegotiation of gas contract prices to market responsive levels. In addition, the proposed Block Billing rule could reduce incentives to explore for gas and thereby adversely impact all elements of the industry. Either the Commission or the Congress should put an end to the uncertainty caused by the Block Billing proposal by terminating it.

ANR Pipeline Response to Order 436

As you may know, ANR Pipeline Company notified the Commission on October 31st that we would continue our transportation services for low-priority users through December 14th under the transition provisions of the Order 436. We have also offered new, non-discriminatory transportation services under Commission self-implementing procedures until December 14th for any and all who request service. We took this step to give our low-priority customers the maximum time available to find an alternate energy source or gas supply. In our notice we stated that we did not intend to file for blanket certificates or otherwise "volunteer" to operate under the transportation rules in Order 436 after December 14th.

In this transition period, our available capacity is usable by producers, end-users and distribution companies alike. We would make this type of service available to our customers and others indefinitely but only if the Commission's new rules do not subject us and our customers to the unfair impacts of the FERC's "ratchet down" conditions, that is the right of any distribution company to reduce its contract demand by 25% per year over a four year period. Unfortunately, this condition makes it necessary for our Company to terminate these new open access services on December 15, 1985, when the grandfather period expires.

Our low priority end-user customers are understandably upset and concerned with the need for us to terminate our transportation services. But we call the Subcommittee's attention to the fact that we sought to serve all of our transportation customers by filing certificate applications prior to the effective date of Order 436's Final Rules. We urged the Commission to approve them on an expedited basis. Regrettably, the Commission failed to act.

In addition, our Company and others through the American Gas Association and the Interstate Gas Association of America attempted to stay the effectiveness of Order 436 until the Commission's related regulations on Block Billing were concluded. While this was based upon the fact that neither pipelines nor distributors could act intelligently until the fate of block billing was determined, it also would have permitted existing transportation and related low cost, spot market sales to continue through the current heating season. The Commission completely overlooked the practicalities of the situation facing pipelines and their customers on November 1, 1985, the effective date of Order 436. Open access can be provided during this period just as our Company is now offering it to all customers until the end of the "grandfather" period. This can be done in full compliance with the order of the Court of Appeals in its Maryland Peoples Counsel cases. Consumers would have benefited from lower rates and many low priority industrial customers would have maintained their current competitive position. The complaints the Congress has received in recent days would have never been made.

Unfortunately, neither the Commission nor the Court of Appeals focused on the fact that the adverse effects of Order 436 would cause many, perhaps most, interstate pipelines not to participate in the new transportation program and that this would cause severe consequences for some gas consumers. The Commission apparently fails to see that the Order 436 transportation program provides few, if any, incentives for pipelines to participate and that many consumers can be significantly injured.

If the Congress believes that natural gas legislation is not a practical alternative at this time, then it should immediately send a message in other ways to the Commission that it should revise its new transportation program to eliminate the "ratchet down" provisions and provide relief from mushrooming take-or-pay obligations. This would induce pipelines to participate. Commission action of this type will clearly benefit consumers of all types, but particularly the industrial customer that relies on spot gas to keep him competitive.

Order 436 Shifts Costs Unfairly Among Customers

I would like to explain ANR Pipeline Company's position. We have concluded that we should not participate in the new voluntary transportation program under Order 436 because of our concern that it would result in an unfair shift in the responsibility for fixed costs between our customers. As previously stated, Order 436 provides that distribution company customers of pipelines participating in the new transportation program may either reduce their contract entitlement and thereby reduce their responsibility for fixed costs or convert their contract entitlement to transportation services. In the first instance only certain "flexible" customers with alternate gas supply capability, as a practical matter, can take advantage of this reduction in demand costs. The remaining "inflexible" customers without adequate alternative supplies will be burdened with increased costs responsibilities (including take-or-pay costs discussed below) shifted to them from the "flexible" customers which have "ratcheted down" their contract demand.

This outcome is particularly unfair to the bulk of our customers, since it ignores much of the contractual and ethical basis upon which the Pipeline was constructed and fixed costs were allocated over the last several decades. During recent rate cases, our customers, the state public service commissions and the FERC have all repeatedly agreed on the appropriate allocation of cost responsibility for ANR Pipeline's fixed costs. The principle which has been followed is that he who has caused the costs to be incurred should be responsible for paying them. Under Order 436, some customers will be able to avoid paying their share of the costs originally incurred for their benefit while others will have to pay more than their original share. We do not believe it is in the consumers' interest to force such a significant departure from the cost allocation principles approved by the FERC as just and reasonable for all customers. As a result, we have not elected to participate.

The second major reason for our decision not to participate is based upon the fact, that while distribution company customers of participating pipelines have the opportunity to reduce their contract obligations, pipelines have no authority to reduce their contract obligations with producers. To the extent that present distribution company customers transport spot gas to their markets, ANR Pipeline Company will incur take-or-pay obligations under its supply contracts. These take-or-pay costs are potentially substantial. Under certain circumstances they could amount to $750 million in the first year under the Commission's new program. This would add about $150 million to our annual cost of service and translates into about 40 cents per Mcf.

This additional take-or-pay cost will not be borne equitably among our customers. We do not expect that all our customers will seek transportation gas in lieu of pipeline purchases, nor do we expect that the proportion of transportation gas to traditional sales gas will be the same between customers.

As a result, the likely effect of Order 436 will be for certain customers, particularly the smaller distribution companies and municipal gas systems which do not have alternate gas supply sources, to pick up a disproportionate share of these additional take-or-pay costs.

Comments on Block Billing

Let me now turn to the remaining unresolved portion of the NOPR, Part D, relating to "block billing". FERC's Order 436 continues to propose to split pipeline gas supplies into two tiers or "blocks" for ratemaking purposes. Block One would contain the lower priced, forever regulated gas. Block Two, on the other hand, would be composed of all other deregulated gas. This latter category currently has an average price well above market clearing which will make the bulk of it unmarketable given the amount of uncommitted gas available at spot prices. While the Commission believes that the consumer will benefit from lower prices, the increased cost to the consumer of take-or-pay payments and the negative impacts on gas exploration efforts have been underestimated. We believe a reevaluation and modification to the proposed Block Billing mechanism is in order.

The high prices associated with Block Two supplies stem from the shortages of the 1970's. Both Congress and the FERC's predecessor agency set up a mechanism for raising natural gas prices in order to increase available supplies. Pipelines perceived their obligation to meet their customers demands as more compelling than the dangers from paying the high prices forced upon them by the competitive environment of the time.

With continued old gas wellhead price regulation and rolled-in pricing for pipeline sales to distributors, pipelines were able to offer prices for new gas at above regulated levels to bring on gas reserves which may not have been developed under total deregulated pricing conditions. Thus, supply capability was enhanced and shortages disappeared.

To help finance exploration for these new gas supplies, the pipelines agreed to purchase gas at prices that are now above market clearing levels and also agreed to either take or pay for certain specified volumes of gas. The system worked too well and the shortages for the 70's turned into the surpluses of the 80's. The surplus gas could not find an outlet in the interstate pipeline markets and the producers needing a positive cash flow to meet commitments began reducing prices in an effort to penetrate markets. Within the framework of its commitments to producers, the pipelines and producers worked to insert these lower priced supplies into the market through a variety of special transportation and short-term marketing mechanisms that are now being replaced or radically restructured by the Order 436 transportation program.

The FERC, however, has viewed these past efforts of the pipelines to market low cost gas as inadequate. The FERC's proposed Block Billing rules are intended to bring all deregulated gas to market clearing prices while keeping forever regulated gas at its current below market levels. If the program works as the Commission expects, consumers will receive a short-term benefit by having spot gas purchased from other producers with uncommitted gas available for sale and transportable under the new open access transportation rules.

These benefits, however, cannot be achieved without causing some economic hardship.

At first, one would expect a difficult period when pipelines would attempt to renegotiate Block Two gas prices down to market clearing levels. The sharp reduction in prices will, undoubtedly, be opposed by producers. Each individual producer will have little incentive to reduce its price since the entire Block Two average price must be reduced to market levels for the producers' gas to become marketable. Negotiating impasses will likely result. Pipelines will be forced to cut back takes. Take-or-pay obligations will increase sharply and litigation over the validity of the contracts will undoubtedly result. All of this will increase costs to pipelines and their customers and offset the expected benefits to consumers which the Commission expects.

To add to the consumers' pain, Block Billing may encourage distributors with alternative supply sources to cut back their contract demands deeper than might otherwise be the case with their new found "ratchet down" rights. They could cut all the way to the Block One level--and replace all Block Two gas with spot or other uncommitted gas. As explained above, this will force an unfair allocation of pipeline costs on the remaining distribution company customers.

As Block Two gas prices are finally negotiated down to market levels, producers will bear the burden of the short-term benefits gained by the consumer. The impact on the producer will be substantial. Their expected return on investments made in contemplation of the pricing provisions of their long-term gas contract will be cut drastically. This will undoubtedly deter future exploration. The increased risk inherent in a market set by spot pricing mechanisms will cause producers to raise their expected rate of return for future exploration investments. To accomplish this, they will limit their exploration projects to only those with assured high return rates. Financing a gas industry which is dependent upon spot pricing will be more difficult to obtain and, when obtained, become expensive. The net effect will be to reduce exploration activity and cause annual reserve additions, which are already below annual production levels, to fall for the industry as a whole. All of this will increase the cost of new gas supplies and ultimately injure consumers.

After the current excess delivery capacity is produced, prices will ultimately increase and low valued customers (boiler users) will find alternate supplies. While it is unlikely that there will be any residential curtailments, residential consumers will face higher delivered prices as they pay pipelines and distributors to make up for the cost contributions previously made by the low valued customers who switched supplies.

It is difficult to measure the claims and counterclaims of costs and benefits associated with this radical departure in gas pricing policies. However, we believe that with a reexamination of the real purposes of the Block Billing mechanism, appropriate modifications can maintain much of the benefits and substantially reduce the costs.

FERC should not be allowed to undertake only the "easy" part of its duty, i.e., eliminating the contractual obligation of distributors by reducing contract demands to enable distributors to take advantage of low spot market purchasers and open access interruptible transportation under the FERC's new program. If this is the route it wishes to follow, then it should make the same adjustment at the pipeline/producer end of the market so the pipelines can compete in the acquisition and sale of uncommitted spot market gas. This type of competition can be achieved quite simply by instituting a separate block within Block Two for contracts which have market sensitive prices as a result of renegotiation or otherwise. This will provide a strong incentive for producers to renegotiate their high priced Block Two contracts which do not have "market out" or renegotiation provisions. Producers can choose to increase their takes by lowering their price as a way to keep up cash flow. With a Block Two subdivision for market sensitive contracts, markets will readjust more quickly with reduced risk of increased take-or-pay obligations and related litigation. The Commission failed to give adequate consideration to this solution to the problems caused by Block Billing. We are continuing to urge the Commission to adopt this solution and believe the Congress should do likewise unless the Commission withdraws the entire Block Billing proposal.

Senator NICKLES. Mr. Smith, thank you very much for your comments.

Next we have Dr. Mark Cooper, energy director of the Consumer Federation of America.

STATEMENT OF DR. MARK N. COOPER, DIRECTOR OF ENERGY, CONSUMER FEDERATION OF AMERICA, WASHINGTON, DC

Dr. Mark COOPER. Thank you, Mr. Chairman.

After several years of disagreeing with the Federal Energy Regulatory Commission and 13 previous witnesses who have disagreed with the Federal Energy Regulatory Commission, I find it pleasurable to take the other side. My message today is simple: Let's get on with it.

The time has come to unleash competition in the natural gas industry by eliminating the monopoly power of the pipelines and allowing consumers and producers to behave at the margin of cost and value in the marketplace.

We urge FERC to pay close attention to monopoly markets, and we're still concerned about how representative volumes will be defined, how costs will be allocated, and whether exit fees can legitimately be charged. But we would much rather launch into the new age—Senator Metzenbaum called it a revolution—of carriage and work to improve it than to continue to suffer the abuses of the pipeline monopoly so recently demonstrated in their near lockstep refusal to participate in nondiscriminatory carriage.

That the pipelines continue to have immense market power is undeniable. There is no alternative means of delivering natural gas to the city gate, and city gate markets are among the most concentrated markets in the Nation; nor is potential entry into the industry likely to discipline market power. Demand elasticities are certainly not large enough to lead us to believe that the lack of competition on the supply side of the transportation market will be disciplined by the demand side. The bundling of services, the direct affiliation between the pipelines and producers, and regulatory mechanisms for passing costs through only compound the weakness of market forces.

The existence of this type of monopoly power requires either detailed regulation or removal of the bottleneck through open access. FERC is clearly not inclined to regulate the monopoly, so let's get on with the second alternative: nondiscriminatory carriage.

Our feeling of let's get on with it goes doubly for block billing. If Congress had intended for the economic rents of old gas to be captured by the owners of that gas, it would have decontrolled all gas in title I. At the same time, in title II NGPA clearly intended that only some classes of customers enjoy the full benefits of the rents of old gas.

Block billing reconciles the equity and efficiency goals of the Natural Gas Policy Act. It faithfully passes the rents from old gas through to historic firm sales customers while encouraging more efficiency on the supply side of the market. Since historic firm sales customers have less elastic demand, block billing will result in the smallest increase in demand and the least deadweight inefficiency on the demand side.

Since old gas does not clear the market, most customers will still be in the market for new gas. At the margin, they should be unwilling to pay more than the value of that gas to them. They should pocket the difference between the price they pay for the marginal Btu in gas and the price they pay for their forever regulated gas as an increase in what economists call consumer surplus. They have absolutely no interest in dissipating their own rents. The pipelines have in fact had an interest in dissipating those rents.

Now block billing will certainly reduce the total revenues received by the aggregate of producers. Until the current surplus of deliverability is reduced, there will be downward pressures on prices and a reduction in drilling. However, some producers will gain by freeing their shutin gas from the tyrany of the pipeline monopoly, and the near-term reduction in drilling will simply be a restoration of order to the supply side of the gas market.

Inventory will be reduced, and the lowest cost supplies will be developed first. But the near-term reduction in prices will simply shift the development of the resource base onto a different time path. The underlying economics will remain the same. The dates will change and there will be no long-term change in supply.

Statements by some producers and pipelines that local distribution companies and public utility commissions might foil the equity and efficiency benefits of block billing are pure sophistry. It's the pipelines who have been dissipating the rents. Far removed from the people, both in the marketplace and in the regulatory arena, pipelines have failed to provide their primary function as agents in the market.

The underpinning of the Consumer Federation of America lies in State and local groups who have cut their teeth on utilities and public utility commissions. Move the old gas cushion closer to the people, and we will ensure that it is passed through to its rightful beneficiaries. Give local distribution companies the right to enter the market in search of lower cost gas, and we will ensure that that right is vigorously exercised in the consumers interest.

There is no justificiation for the delay in block billing, and FERC must not hamper consumers from entering the market as in delaying reductions in contract demand. FERC rightly proposed a combined package of changes. It has incorrectly separated the parts of that package. Let's get on with it. All of it.

Thank you.

[The prepared statement of Dr. Mark Cooper follows:]

TESTIMONY OF

DR. MARK N. COOPER

DIRECTOR OF ENERGY,

CONSUMER FEDERATION OF AMERICA

Mr. Chairman and Members of the Committee,

My name is Dr. Mark N. Cooper. I am Energy Director of the Consumer Federation of America (CFA). The Consumer Federation of America is composed of 200 consumer, senior citizen, low-income, union, farm, public power and cooperative groups representing more than 35 million people.

Natural gas is the dominant residential heating fuel, utilized by over 47 million households, approximately 56 percent of the national total. Policies affecting natural gas prices and availability are of vital concern to consumers.

In my testimony today I will address two issues. First I discuss the need for open access to transportation. Second I examine the economic and equity rationale for block billing.

In both cases my message is simple. Let's get on with it. There are changes we would like to make in a number of areas, and we will work hard at the Federal Energy Regulatory Commission (FERC) to do so, but the time has come to unleash competition in the natural gas industry by eliminating the monopoly power of the transportation bottleneck and forcing consumers and producers to behave at the margin of cost and value in the marketplace.

THE NEW AGE OF TRANSPORTATION

Anyone who has ever read the filings of various parties before the Federal Energy Regulatory Commission (FERC) knows that pipelines have a huge stable of regulatory lawyers who grind out tomes. However, I am convinced that the pipelines need a new stable of lawyers, a stable of antitrust lawyers.

Regulatory expertise is loosing its value. A new age is dawning in the natural gas industry. Responding to the strong signals sent by the courts that the old patterns of access to the transportation of natural gas violated the antitrust principles of this nation, the FERC has declared that it wants greater competition. The courts came pretty close to declaring that the public agency administering a major industry had violated the antitrust laws.

The pipelines seem to have failed to get the message. The almost lock step refusal to engage in transportation will attract the attention of more than the Federal Energy Regulatory Commission, who, I suspect, it was intended to influence. It should also attract the attention of the Department of Justice and the investigatory Committees of the Congress.

I do not know whether the antitrust laws were violated in the mass decision not to participate in the FERC gas transportation program, but let the pipelines make no mistake about the fact that the consuming public intends to have open access to the transportation of natural gas. If the pipelines continue to resist, particularly in the heavy handed way they have, they will need two new stables of lawyers -- they will need a stable of criminal lawyers to go along with their herd of antitrust attorneys.

When I testified before this Committee early in the summer, I complained about the carriage proposal that FERC had on put the table. Some may have come away with the misimpression that I was against contract carriage. That is not the case. I wanted to improve the carriage proposal,pointing out that "the residential consumer will be the loser in the FERC scheme, not because carriage and expanded reliance on competition cannot work, but because the scheme proposed by FERC is poorly conceived and riddled with contradictions."

I raised three general areas of concerns about the proposal -- price discrimination, cross subsidy and low densitymarkets. In the final rule, the FERC has made some efforts to respond to these concerns.

It has recognized that monopolized markets will continue to exist and it has entertainedthe possibility that it will have to revisit the regulation of these markets. We urge the Commission to pay close attention to these markets and we will be quick to point out difficulties that arise.

Recognizing the potential for cross subsidy, it has instituted a system of reservation charges and has acknowledged the importance of representative volumes.

We are still deeply concerned about how representative volumes will be defined, how costs will be allocated, and how risks will be placed on pipelines to go along with the potential rewards they can reap through selective discounting, but our general feeling is, let's get on with it. We would much rather launch into the new age f carriage and work with the Federal Energy Regulatory Commission to improve it than continue to suffer the abuses of the pipeline monopoly so recently demonstrated by their refusal to participatein nondiscriminatory carriage.

THE JUSTIFICATION FOR BLOCK BILLING

The feeling of let's get on with it goes doubly for block billing. The block billing proposal under consideration is of special importance to consumers. Since they are predominantly historic, firm sales customers, they would be the primary beneficiaries of block billing.

Block billing will be much more than just a boon to consumers, however. It would be a primary mechanism for restoring order and fostering efficiency in the natural gas market. Block billing will simultaneously implement the equity policy Congress intended in the Natural Gas Policy Act (NGPA) and force producers and consumers to behave at the true margin of cost and value in their transactions.

It is important to recognize that the decision not to decontrol old gas in Title I of the NGPA is a fundamental decision about the allocation of the economic rents associated with old gas. If Congress had intended for these rents to be captured by owners o that gas, they would have simply decontrolled all gas.

At the same time, the NGPA clearly intends that only some classes of consumers enjoy the full benefits of the rents from old gas. The incremental pricing scheme of Title II allocates the higher costs of deregulated gas to non-residential consumers.

As has been noted by many, the combination of certain categories of forever regulated gas, rolled-in pricing and certain categories of decontrolled gas created the possibility of distortion. The rents from old gas coul be dissipated by bidding up the price of decontrolled gas (or even driving the price of new gas higher than it should have been). This would foil the intent of Congress on both counts, robbing consumers of the benefits of old gas and creating inefficiency in the supply of new gas.

The existence of prices well above market clearing levels paid for some gas has been taken to be proof that rents are being dissipated. The entire old gas cushion has not been dissipated, however, and with larger quantities of gas decontrolled the potential for rent dissipation could increase. While the spectacularly high prices for small quantities or categories of gas would be less in evidence, the actual distortion by a systematic overpricing of all decontrolled gas would be larger.

Since the passage of the NGPA, FERC has faced a problem of allocating the economic rents of old gas to consumers while introducing the least distortions into the market. Block billing adopts and extends the two fundamental principles embraced by Congress. Block billing reconciles these two conflicting goals. It faithfully passes the rents from old gas through to historic, firm sales consumers while encouraging more efficiency on the supply-side of the market. In light of the recent decontrol of large quantities of gas at the wellhead, it should move forward with block billing immediately.

The concerns expressed by some producers and pipelines that the local distribution companies and the Public Utility Commissions might foil the equity and efficiency benefits of block billing are facetious and pure sophistry. Right now the pipelines control the cushion and, given the regulatory structure at FERC, there is little that can be done to force them to behave in an equitable and efficient manner. Far removed from the people, both in the marketplace and in the regulatory arena, they have failed to perform their function as agents in the market.

The underpinning of the Consumer Federation of America lies state and local groups who have cut their teeth on utilities and public utility Commissions. Move the old gas cushion closer to the people, and we will ensure that it is passed through to the rightful beneficiaries. Give local distribution companies the right to enter the market in search of lower cost gas and we will ensure that this right is vigorously exercised.

There is no justification for the delay in block billing proposed by FERC. Indeed, any delay will frustrate the efficiency objectives of FERC by encouraging inefficient pipelines to dissipate the gas cushion as rapidly as possible for as long as they continue to have control over it.

FERC must also move forward with the other elements of the final rule that will enable consumers to enter the wellhead market with access to nondiscriminatory transportation. If FERC prevents price inelastic consumers from entering the market (as in delays in reductions in contract demand) it will effectively deny them the benefits of block billing, since contract obligations will preclude them from operating in the market. FERC rightly proposed a combined package of changes. It has incorrectly separated the parts of the package. Let's get on with it, all of it.

Having outlined our support for both block billing and open transportation, I will next turn to a detailed discussion of the theoretical and empirical facts which lead us to this position.

THE MONOPOLY CHARACTER OF THE NATURAL GAS PIPELINE INDUSTRY

Since the natural gas industry is entering into a new age of competitive transportaion, driven in part by the recognition that antitrust concerns must be taken much more seriously by the industry, I will make the case for open transportation by conducting a traditional antitust analysis of the industry. I will examine the key characteristics of industrial organization that determine market power -- concentration, demand elasticities and institutional arrangements.

THE SUPPLY SIDE -- CONCENTRATION AND ENTRY

In the recent debate over the natural gas industry, concentration ratios of various forms were used to assess the competitiveness of various market segments.

The pipeline gathering market is moderately concentrated. Looking at national figures, the four firm concentration ratio is 30 percent, but the nation is no the relevant market. Looking at producing regions, there are only one or two areas where the concentration ratio is even close to 30 percent. In virtually all cases, the four firm concentratio ratio is closer to 90 percent. The exceptions, however, are Louisiana, Texas and Oklahoma, which accounted for about three-quarters of all gas produced in 1979. On a volumetric weighted basis, the four firm concentration ratio for pipeline gathering markets was approximately 57 percent.

Concentration in the city gate market is much higher. Four firm concentration ratios would be 70 percent on a volumetric weighted basis and probably 90 percent on a simple numeric basis. By volume, one-eighth of all local distribution companies have only one pipeline. By volume, the average number of pipelines servicing distributors is about 3.7. On the basis of a simple count of local distribution companies, the averae is only about 2 pipelines per company and seven-tenths have only one pipeline.

To put this in perspective, at least a third and perhaps two thirds of all markets would have Hirschman/Herfindahl Indices (HHI) over 5000. At least 80 percent and perhaps 95 percent would have HHIs over 2500. By antitrust standards these are highly concentrated markets.

Head-to-head competition (intramodal competition) does not exhaust all potential or actual competition for most transportation/communication industries. For other industies intermodal competition significantly affects the level of concentration in a number of markets. By intermodal competition we mean technologies which are cost competitive alternatives for delivering the good or service into a specific market. This is not the case with natural gas pipelines. They are not subject to intermodal competition. At the distribution end there is no other means of delivering gas.

Our conclusion is that competitive forces are extremely weak in thesupply of transportation services. Although an integrated national network exists, the private ownership of the pipelines and the highly concentrated nature of the industry leads us to the conclusion that it will not be likely to function well. In traditional terms, its industrial organization causes concern about its likely market performance.

Nor is potential entry into the industry likely to discipline market power. Large capital requirements, sunk costs and problems of achieving minimum levels of efficiency are present. The network quality of gas transmission probably compounds these problems by making the requirements for achieving network status and managing the network more important and difficult.

At best, with the national pipeline network havig achieved considerable density, the possibility of building relatively short extensions or tap lines has become more attractive. Such competitive entry would certainly be restricted to high volume markets where minimum levels of efficient operation could easily be achieved. This reinforces the need for strict adherence to non-discrimination in carriage.

THE DEMAND-SIDE -- ELASTICITIES

Absent forces to discipline market power on the supply-side, our conclusion that the market is not likely to perform well could be reversed if there were extraordinarily strong forces on the demand side. If demand elasticities were very high, we might conclude that market power in the provision of transportation services will not be abused.

Again this simply is not the case. The elasticity of demand in the residential and commercial sector is estimated to be about In the industrial sector price elasticities are estimated to be somewhat higher in both the short and long terms. Over time, it appears that the price elasticity in the industrial sector has increased much more than in the residential sector because of the addition of dual-fired capacity. Cross price elasticities appear to be in the .3 to .4 range.

These are not high elasticities by any means. They are certainly not high enough to reverse the conclusion that we reached on the supply-side of the market. If anything, they reinforce those conclusions.

INSTITUTIONS -- STRATEGIC INTERACTION AND REGULATION

Our concerns about the weakness of competitive forces are reinforced when we observe the institutional arrangements under which these forces operate. We have stated these several times in the past before the Committee.

The bundling of services -- purchase, transportation and storage -- is a cause of considerable concern. When this bundling extends to the direct affiliation between pipelines and producers, the potential for abuse is multiplied. Contracting practices have been rigid and slowed market reactions. Mechanisms for the pass through of costs dampen incentives to hold costs down.

THE NEED FOR CONTRACT CARRIAGE

Thus, on all three counts the pipeline industry appears to be one which leans toward a poor market performance. The experience of the past half decade reinforces and substantiates that conclusion.

Pipelines will argue that a unique set of circumstances led to aberrations in the marketplace and that these aberrations are being reduced. We view discriminatory carriage, which has been the leading edge of the industry's response, as a regime which does a rather bad job of treating only the worst symptoms of a very serious disease.

There are only two solutions to the existence of this type of monopoly power -- detailed regulation of the natural monopoly or removal of the bottleneck through open access. FERC is clearly not inclined to regulate the monopoly so let's get on with the second alternative -- nondiscriminatory carriage.

BLOCK BILLING

I have already pointed out that it is overwhelmingly clear that the block billing proposal is the embodiment of the equity decision contained in the NGPA. Given the fact that Congress intended for the economic rents of old gas to be passed through to consumers, let us examine how block billing will affect the economic performance of the market.

THE DEMAND-SIDE EFFICIENCY OF BLOCK BILLING

Block billing will minimize the economic losses associated with allocating the rents of old gas to consumers. Assuming that historic firm sales customers have less elastic demand, block billing will result in the smallest increase in demand and the least deadweight inefficiency on the demand side.

Moreover, since old gas constitutes only a fraction of total supply (generally around half), most consumers will still be in the market for new gas. At the margin, they should be unwilling to pay more than the value of the gas to them. They should pocket the difference between the price they pay for the marginal BTU of gas and the price they pay for their forever controled gas as an increase in consumer surplus. They have no interest in dissipating their own rents.

The pipelines who have had control over the old gas cushion have a different set of incentives. With purchased gas pass through clauses there was little, if any disincentive to dissipate the cushion. Insofar as they had affiliated production, they benefited from the generally higher price paid for new gas. Even if these specific flaws were removed, it is highly unlikely that the small number of pipelines would be as vigorous in capturing the benefits of the rents of old gas for consumers as consumers, themselves, would be themselves.

THE SUPPLY-SIDE EFFECTS OF BLOCK BILLING

It is obvious that if block billing will reduce or prevent the dissipation of the rents of old gas, it will reduce the total revenues receive by the aggregate of producers. Marginal prices for gas will fall as consumers seek to increase their consumer surplus by refusing to use the rents of old gas to subsidize the production of new gas. Certainly until the current surplus of deliverability is reduced there will be downward pressures on prices. The result will be a reduction in drillin.

The near term reduction in drilling will simply be a restoration of order to the supply-side of the market. Assuming that the other elements of the proposed rule function properly, inventory will be reduced and the lowest cost supplies will be developed first. The primary impact should be vigorous efforts to take advantage of potential price increases for controlled gas through reworking old fields and old wells and much less effort expended on higher cost sources of supply. The transitional period will witness a reduction in the national R/P ratio. If such a reduction is deemed intolerable by individuals in the market, then consumers will bid up the price of gas or increase the length of contracts in an effort to find R/P ratios that make them feel more secure.

The assertions that this will constitute a long-term supply problem are completely unfounded. The near term reduction in prices will simply shift the development of the resource base onto a different time path. The underlying economics will remain the same.

EMPIRICAL ANALYSIS

The above arguments on block billing have been made and challenged in more or less detail by various parties in the previous set of comments filed in response to the proposed rule. To highlight the points of contention, I next present a gaphic conceptual presentation of the our case. The underlying data and assumptions are drawn from the current natural gas market bu the argument is simplified.

Ultimately, whether one accepts these arguments turns whether one accepts key assumptions about the nature of underlying supply and demand elasticities and the extent to which the distortions introduced into the natural gas market by the combination of partial decontrol and full rolled in pricing have masked the true nature of the supply curve. These are essentially empirical, not theoretically questions. We believe that assumptions which are reasonably consistent with relity fall in a range that clearly leads to the conclusion that block billing would increase efficiency without seriously affecting long term supply prospects.

Exhibit 1 depicts the natural gas market at the end of 1985, based on 1984/85 actual figures. There are approximately 4 trillion cubic feet (TCF) of old gas sold at an average of $1.40 per MCF. Another 4 TCF of new gas was sold at an average price of $3.60 per MCF. About 1 TCF of high cost gas was sold at an average price of $4.61 per MCF. Average, fully rolled in prices, referred to as AC(FRP), were $2.78/MCF. The average price for what would be Block 2 Gas would be $3.78 per MCF. Spot prices were about $2.50 per MCF.

Note that the supply curve for old gas has been drawn to clear the market at the spot price. This embodies an assumption that in the short term production would be expanded as long as it covers short run variable costs, a situation that probably typifies forever regulated gas.

Aggregate market demand is assumed to be linear with a short to midterm elasticity of -.35. This aggregate demand results from approximately equal quantities of demand in the price elastic sector, where the elasticity is assumed to be -.5 and the price inelastic sector where the elasticity is assumed to be -.2.

The observation that block billing will lead to less inefficiency on the demand side is demonstrated in Exhibit 2. The aggregate demand in the market has been divided into two equal parts. The first part is price inelastic demand (labeled D(R,C) to reflect the fact that the bulk, although not all, of this demand is located in the residential and commercial sectors). The second part is price elastic demand (labeled D(I) to reflect the fact that the bulk, although not all, of this demand is located in the industrial sector).

The fact that average rolled in prices are paid by consumers results in higher demand than if marginal costs were charged. The increase can be estimated as follows:

Percent Price Difference X Demand Elasticity X Demand =
Incremental Demand Due to Price Difference

Assuming a $1.00 difference between marginal and average rolled in prices, we estimate "excess demand" in the price inelastic segment of the market at about .3 TCF ($1.00/$2.78 X .2 X 4.5 = .323). We observe about .8 TCF "excess demand" in the price sensitive segment of the market ($1.00/$2.78 X .5 X 4.5 = .809).

Based on the simplified situation in Exhibit 2 we can make a rough estimate of the inefficiency associated with rolled in pricing. The "excess demand" results in a deadweight loss to the economy which is equal to the resources spent by society for the exploration and development of gas (as measured by the height of the supply curve) in excess of the value of the gas to society (as measured by the height of the demand curve). This is estimated as follows:

Price Difference X Excess Quantity Consumed/ 2 =
Deadweight Loss

We estimate a loss of about $560 million (1.1TCF X $1.00/2).

The situation is actually more complex as depicted in Exhibit 3. Because of uneven allocations of low priced gas and other institutional arrangements, some gas is produced and sold at the well above the Block 2 average price. The deadweight loss associatedwith this extraordinarily high cost gas is approximately $200 million (.5TCF X $.80/TCF / 2). Thus, the total deadweight loss is approximately $750 million.

Thus, even if one were to assume that the rents of old gas would be dissipated when placed in the hands of price inelastic consumers, one would conclude that the damage they would do would be perhaps only one half as large as the damage that is currently being done. Moreover, we believe that they will not dissipate the rents because there is too mch to gain.

The potential gain for consumers in terms of consumer surplus is also depicted in Exhibit 3. As a starting point, we assume (as some have) that the market would continue to clear at the current average price of $2.78. Block 2 Gas would be driven down to that price. Block 1 Gas would remain at an average of $1.40. The average price with block billing,labeled AC (BB) in the Exhibit, would be about $2.16. This appears to be the assumption made in the numbers estimated by Citizens Energy Corporation.

The underlying assumption here is that there would be a rather sharp shift in the supply curve. It assumes that the same quantity of gas would be delivered at a price that is over one-third lower at the margin. In the short term, and given the continuing excess of deliverability reflected in spot prices below average rolled in prices, this could well be the case. For the long term, however, it is not clear whether this situation would prevail.

Exhibit 4 depicts alternative assumption about the behavior of the supply curve. Foster Associates appears to have assumed that prices would fall below the current rolled in level to current spot market lvels.

The argument of producers who are predicting a collapse of the supply-side is that this short term response will shut down drilling as producers sell from existing inventories. There is no reason to believe, however, that this will affect long term behavior. Demand for new gas will continue to exist and producersare likely to find a more stable environment because of direct access to wider markets.

Contrary to producers, DOE assumed the marginal price would rise above current levels. This is the "ormal" market assumption. Producers, faced with lower prices at the margin, cut back supplies. Consumers, faced with reductions in available supplies, bid prices up above current levels. The equilibrium price in the new gas market will be higher than the current price.

Our argument presented earlier is a combinaion of several aspects of the basic cases in Exhibit 4. We do believe that there has been a suppression of low cost supplies. Along with Citizens Energy and Foster, we believe the inframarginal section of the supply curve will shift to yield higher supplies at lower prices. The response will not be large enough to clear the market at current average rolled in prices and certainly not after the gas bubble disappears (see Exhibit 5).

There is no reason to believe that the market for new gas has been completely distorted. As noted earlier,the dissipation of the old gas cushion has not been that pervasive. Thus, the supply curve is likely to shift, but not as much as suggested by the argument that the same quantity of supplies will be delivered at a lower price. Even if the elasticity of supply remains the same (which is the situation depicted in Exhibit 5) the price would rise.

xhibit 5 depicts the following situation. Based on estimates of the potential old gas response of a total of 10 to 25 TCF, we would expect that something on the order of 1 to 2 TCF of increased old gas would result from block billing. Combined with other potential lower cost sources of supply that have been shut in, we might envision 5.5 TCF of "low cost gas (old or near old)" for a decade. The new gas supply curve would then determine the market clearing pric. Some of the gains in consumer surplus would be offset by increases in the marginal price necessary to clear the Block 2 market, but consumers would be far better off in terms of bothequity and efficiency.

EXHIBIT I

SUPPLY AND DEMAND IN THE NATURAL GAS MARKET

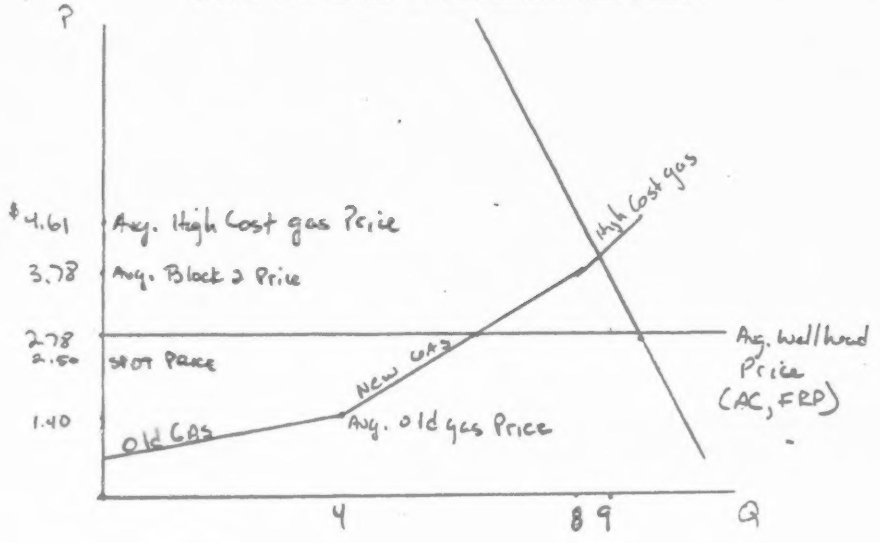


EXHIBIT II

EFFICIENCY GAINS FROM BLOCK BILLING

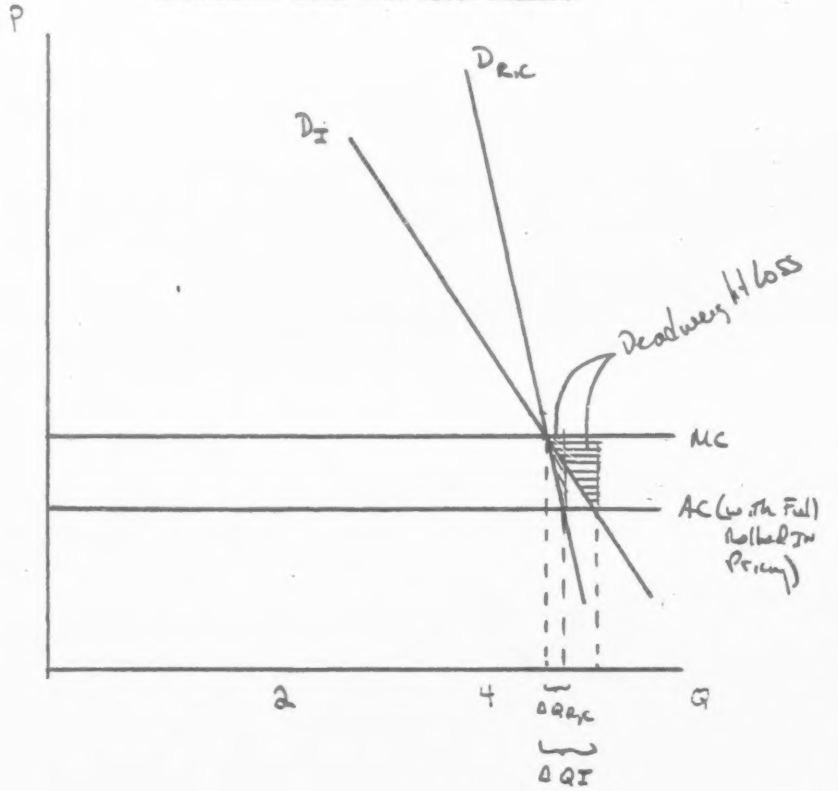


EXHIBIT III

CURRENT DEADWEIGHT LOSS AND POTENTIAL CONSUMER SURPLUS GAINS

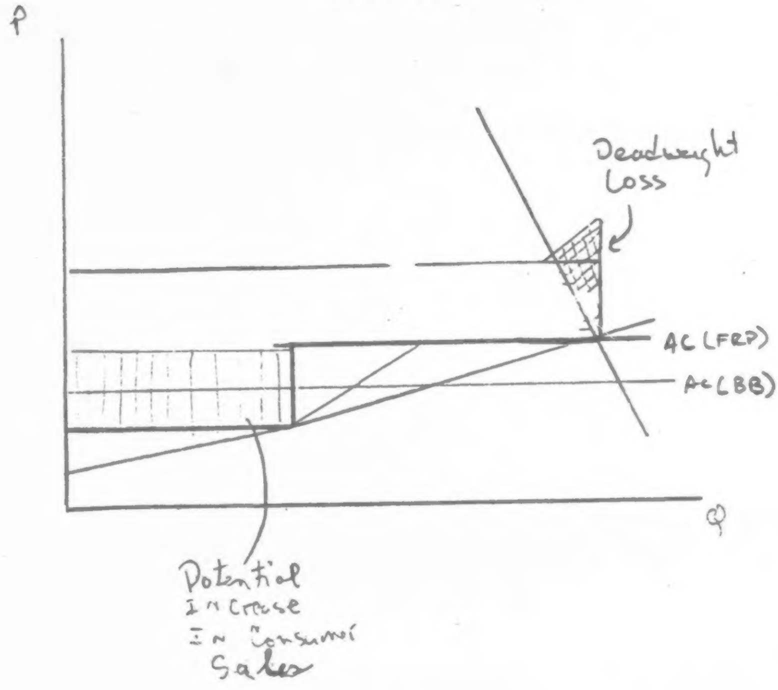


EXHIBIT IV

ALTERNATIVE CONCEPTUALIZATIONS OF SUPPLY IN A BLOCK BILLING MARKETPLACE

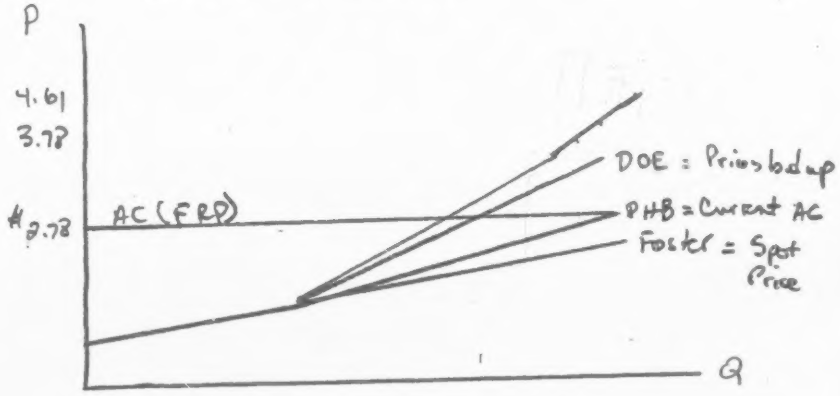
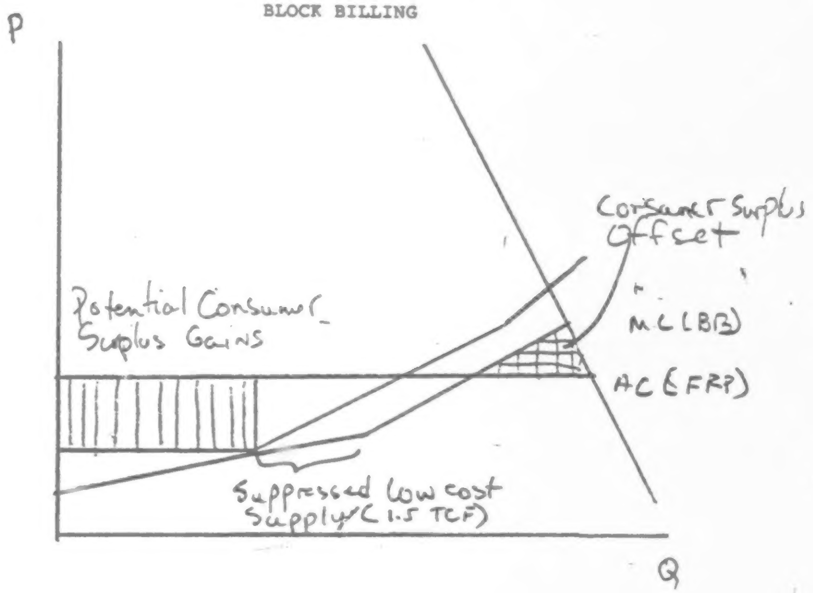


EXHIBIT V

LIKELY MARKET OUTCOME UNDER

BLOCK BILLING



Senator **Nickles**. Dr. Cooper, thank you very much.

Our next panelist we have is Carmen Legato, counsel, of Swindler & Berlin, representing the National Association of State Utility Consumer Advocates and also the Maryland People's Counsel.

STATEMENT OF CARMEN D. LEGATO, ESQ., SWIDLER & BERLIN, REPRESENTING THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES AND THE MARYLAND PEOPLE'S COUNSEL

Mr. **Legato**. Thank you, Senator Nickles.

I'm speaking on behalf of NASUCA, whose members are in 31 States are the State officials who by State statute are charged with the responsibility of representing the interests of residential and in some cases commercial consumers of natural gas. We heartily endorse the thrust of Order 436, the purpose of which is to secure to independent producers and to consumers alike the benefits of an open and fair system of competition.

Senator **Ford**. I apologize for interrupting, but you say you represent State officials?

Mr. **Legato**. Yes, sir.

Senator **Ford**. And they would be in the attorney general's office, or what? I want to be sure I get that right, having been an old State official myself.

Mr. **Legato**. Well, in West Virginia——

Senator **Ford**. I'm not from West Virginia. Try Kentucky.

Mr. **Legato**. Excuse me, Senator.

Senator **Ford**. That's perfectly all right. [Laughter.]

Mr. LEGATO. Let me see. We do have a representative in Kentucky. I don't know if it is--in that case, it is something called the State Public Utility Consumer Advocate, or in that case whether it is a division of the attorney general's office. I can supply that for the record.

Senator FORD. I would like you to do that, because you're speaking on behalf of my State as an elected official of that State, and I just want to be sure who you're speaking for from my State.

Mr. LEGATO. I will get you the name, Senator Ford.

Senator FORD. I would appreciate that very much.

Mr. LEGATO. These officials just met, by the way, in New York and unanimously adopted the views——

Senator FORD. Well, if they were in New York, we didn't have enough money to send ours there. [Laughter.]

Mr. LEGATO. I would—Senator Nickles, I'd like to talk for a moment, to depart from the thrust of my argument for a minute. I think that you have been significantly misled by a number of misrepresentations and mischaracterizations that have been made to you by the pipeline industry and a few of the major producers.

In a short while we'll have a press conference at which, it will be linked to Oklahoma City where independent producers will tell you why, in effect, you are embarked on the wrong path. Some of the independent producers support Order 436 and support nondiscriminatory transportation, and in particular——

Senator NICKLES. Now you're starting to meddle when you pull it into Oklahoma City. Go ahead. [Laughter.]

Mr. LEGATO. Their interest, Senator, is not different from that of consumers. Their interest is in getting gas that is at a market price to market, give them a fair shot at the markets. And that's what the Commission's Order 436 is all about.

Before Order No. 436, the pipeline companies were allowed to undertake transportation programs that were discriminatory. They would make available transportation of competitively priced gas to 25 percent of the Nation's consumers, those that had fuel-switching capability. They refused to provide transportation service that would allow the local distribution companies purchasing for the 75 percent of the captive consumers that lack fuel-switching capability from producers who are willing to sell at a market price.

The independent producers, in particular, have been forced to accept lower prices in order to move their gas, and yet they find that they're being shut in anyway by the pipeline companies which are taking gas predominantly from some of the major producers that have more clout and staying power in court, and are still selling gas to these people at $4.59 per million Btu, and Shell Oil Co. selling to Columbia some gas at $8.80.

Now the point is, the Federal Energy Regulatory Commission has said, in trying to implement the Court of Appeals decisions in the Maryland People's Counsel cases, that this system suppresses competition because the captive consumer lacks any access to the competitively priced gas, and it eliminates all pressure on the pipeline company to reduce its gas to a market clearing level, thereby benefiting all producers and consumers because they face these contracts that they don't want to renegotiate and are not renegotiating especially with the major companies, but they would be forced to in effect if there were more competition.

The court said that the only thing that's lawful under the Natural Gas Act if you're going to authorize transportation, is to authorize it on behalf of all consumers. In particular, the provision that allows firm customers to use the capacity that's been reserved to them in order to have firm service, delivery service, the FERC said the pipeline company can't say any longer we won't let you use that firm service for what you're paying to get gas from a lower cost supplier.

Let the distribution companies, they said, make their own choice of who to buy from. Now you're heard from the pipeline companies a lot of spurious contentions that this is contract abrogation, and that this is unfair to them. That is just simply not true.

First of all, they say that they would become the backup supplier. They would have a continuing obligation to sell gas to these distribution companies who then could swing on and off of the system. That is patently untrue.

The FERC provided that, to the extent the distribution company exercises the option to convert the firm delivery service so that they can buy gas from someone else instead of the pipeline, that that automatically terminates any obligation on the part of the pipeline company—automatically, by force of law, terminates any obligation on the part of the pipeline company to sell gas in the future to that distribution company.

Point No. 2, they claim that this constitutes contract abrogation at the distribution end, and that therefore it's unbalanced because they're still liable under contracts with producers. Again, not true. All of the pipeline companies raised that issue in the United States Court of Appeals for the District of Columbia Circuit in the *Wisconsin Gas* case, and on August 20, 1985, that court said that the pipelines contention that this amounted to contract abrogation did not warrant textual discussion.

In a footnote, they said: "This claim is frivolous." So much for the contract abrogation argument.

The third point is that they will be faced with these enormous take-or-pay liabilities. Again, not true. The take-or-pay liability doesn't exist in their statistics for all the gas—the full purchase price of the gas. When they back off on takes from the major oil companies who are trying to seek a preserve on that local distribution company market that the independents want into, what will happen is they will cut back the major producers, and the major producers will sell their gas at a lower price to someone else.

The only contract obligation they have is to pay the difference between the market price for the gas and the contract price—not these billions of dollars that they claim.

In addition, those differences are being passed through now as supercompetitive prices, monopoly prices for gas, and they're having the undesirable effect of causing consumers to invest millions of dollars in electric heat pumps, and wood-burning stoves, and causing powerplants not to convert to gas.

So reduced prices would increase demand, would increase the flow through the system, would increase cash-flow to producers, and would improve economic efficiency.

Another point. They contend that shareholders will take it on the chin if they have to settle these take-or-pay claims with producers. Again, untrue. Read the FERC rule that says we will allow them to pass through, dollar for dollar, any prudently incurred expense in connection with the buyout or settlement of a contract dispute with a producer.

Now what's unfair? What's unbalanced about that? What are they screaming about? I'll tell you what the real dispute is about. That is simply that they don't want to go through these prudency hearings. They want, despite the fact that they're regulated because they're monopolies, not to have to go through a procedure whereby the FERC can look at and examine some aspects of their operations and their expense and determine whether or not they were prudent, and disallow recovery of imprudently incurred expenses, because the FERC has given them the right to obtain all prudently incurred expenses in connection with these take-or-pay payments from the ratepayers.

[The prepared statement of Mr. Legato follows:]

TESTIMONY OF CARMEN D. LEGATO, ESQ.
Member, Swidler & Berlin, Chtd.
On Behalf of the Maryland People's Counsel and the
National Association of State Utility Consumer Advocates

Introduction and Summary

My name is Carmen D. Legato. I am a member of the firm of Swidler & Berlin, Chartered, in Washington, D.C. I am appearing on behalf of the National Association of State Utility Consumer Advocates ("NASUCA"). NASUCA is a membership organization of state officials in thirty-one states that under state law are required to represent the interests of residential consumers and, in come cases, commercial consumers of natural gas.

These state officials heartily endorse the thrust of the FERC's Order No. 436 and its proposal on Block-Billing. To the extent that it prevents pipeline companies from providing transportation service on a discriminatory basis, Order No. 436 promotes economic efficiency and the mutual interest of producers and consumers in a competitive and efficient marketplace undistorted by the pipelines' monopsony and monopoly power. Order No. 436 is designed to stop the monopoly pricing that has flourished over the last 2-1/2 years because of discriminatory transportation. Monopoly pricing has unnecessarily increased gas costs to consumers, resulted in wasteful expenditures for equipment such as wood-burning stoves and electric heat pumps and has reduced the competitiveness of the segment of American industry that has been ineligible to receive competitively priced gas under anticompetitive restrictions on transportation imposed by pipelines. The result has been to reduce demand and output, shutting in independent producers of natural gas and harming the economy.

Order No. 436 will eliminate the discriminatory practices of pipelines that an ideologically diverse but unanimous Court of Appeals panel found to be anticompetitive: The Court said that the discriminatory transportation practices result in price discrimination, monopoly pricing and economic inefficiency. Order No. 436 eliminates opportunities for price discrimination and monopoly pricing in the following way: If a pipeline company's unregulated costs for gas paid to its affiliated production company or to other producers is above market-clearing levels, it will lose sales, and hence transmission revenues for transporting gas to fuel-switchable consumers. The loss of revenue would induce it to lower its prices to a market clearing level for all consumers. Alternately, the pipeline can transport cheaper, market-priced gas to regain lost sales, provided it makes transportation available on a non-discriminatory basis to local distribution companies (LDCs) that would pass on the benefits of the lower-priced gas to captive residential and commercial consumers. Thus, captive consumers as well as the fuel-switchable and large industrial end-users would receive competitively priced gas. To have captive consumers receive the benefits of competition among producers, FERC provided that LDCs could use the transportation capacity for which they pay the pipeline to use on a firm basis, to buy gas either from the pipeline or from independent producers or independent marketers. To the extent that the

LDC chooses to purchase from someone else, the pipeline has no further obligation to sell gas to the LDC thenceforth.

The ability of LDCs (and captive consumers) to buy gas from numerous producers will create competition in the supply market that will drive down prices to a market-clearing level. Conversely, no producer -- particularly small independent producers -- can be forced to accept a price below market since they will have access to LDCs and end-users willing to pay the market price.

As competition drives prices to a market-clearing level, pipelines will be forced to renegotiate contracts with producers that call for prices above market. Currently, pipelines are buying out of some of these contracts for cash settlements of $.10 to $.15 on the dollar. FERC's Order No. 436 allows pipelines to recover these settlement payments from consumers if they were prudently incurred. Only to the extent that pipelines were imprudent will pipeline earnings be diminished.

Order No. 436, therefore, fairly responds to the Court of Appeals' decisions finding existing transportation arrangements to be anticompetitive in that they allow monopoly pricing. Pipelines have no legitimate reason to refuse to participate in the Order No. 436 program.

My principal focus is on the pipeline industry's claim that legislation is needed because the nondiscrimination requirements of Order No. 436 giving LDCs access to independent producers abrogate their contracts with LDCs and unfairly result in the pipelines incurring unrecoupable contractual obligations to producers. To the contrary, the FERC Order does not abrogate contracts as claimed and is not unfair. LDCs are under no contractual obligation to buy gas from pipelines; their only obligation is to pay for transmission capacity that is reserved for their use. Pipeline companies will not lose transmission earnings under Order No. 436. Their contract abrogation argument is a red herring. In a similar context, the U.S. Court of Appeals on August 20, 1985 squarely rejected the argument as "frivolous."[1]

The pipelines' true contention is that to the extent that LDCs can use pipeline capacity to purchase gas from the lowest-cost suppliers, including independent producers, the pipeline no longer can pass through above-market prices for gas. The resulting competition will trigger the need to renegotiate long-term contracts with the largest producers, the major oil companies, to market-clearing levels, but this is neither harmful nor unfair to pipelines.

In the face of the Court-imposed requirement that regulation not be used to shield pipelines from market pressures, the industry is beginning to renegotiate wellhead contracts to market-clearing levels without undue hardship to pipelines. Indeed, as noted above, Order No. 436 authorizes pipelines to pass-through to consumers prudently incurred expenses in connection with settlement of contract disputes, and INGAA's statistics of staggering theoretical take-or-pay burdens are wholly at odds with the pipelines' actual experience.

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[1] Wisconsin Gas Co. v. FERC, 770 F.2d 1144, 1153 & n.9 (D.C. Cir. 1985).

But the key point is that the market pressures that Order No. 436 attempts to restore are healthy and are the stimulus essential to power the transition to competitive levels of gas costs. The transition is essential, moreover, to the future vitality of all segments of the industry, to the avoidance of economic waste and to improve the competitiveness of American industry. Change of this kind is the everyday stuff of commerce. For example, labor pacts have been renegotiated in the automotive and airline industries to meet foreign and domestic competition. The pipelines have not shown a compelling need for legislative intervention to recast contracts with producers that pipelines freely negotiated or to upset the administrative process.

We do not claim Order No. 436 to be perfect, and we will pursue efforts in the administrative process to overcome deficiencies; we ask this Committee to tell the pipelines to do the same and to also tell them to cease their anticompetitive conduct and to instead provide nondiscriminatory transportation now. We are resolute in our determination to oppose any effort that is made to stop or alter the FERC rule to the disadvantage of millions of consumers that have been victimized by anticompetitive and discriminatory practices.

We urge you not to fall into the pipeline industry's snare which is to commence a legislative process that will never reach fruition and whose only purpose is to distract attention from the source of the problem: anticompetitive behavior by pipelines. Below, I will provide more detail concerning Order No. 436 and its effects on consumers, producers and pipelines.

Background of Order No. 436

The genesis of Order No. 436 can be traced to Congress's enactment of the Natural Gas Policy Act of 1978 ("NGPA"). Prior to 1978, wellhead prices were regulated and cost-based.[2] In enacting the Natural Gas Policy Act of 1978, however, Congress mandated that competition among producers rather than direct regulation should establish wellhead prices for all new gas. Congress "phased" the transition to deregulation. All newly developed gas was removed from FERC's cost-based price controls (that is, deregulated) in November 1978.[3] Prices for this gas were to be determined in the market place subject to statutory price ceilings which escalated monthly until removed entirely on January 1, 1985.[4]

When Congress enacted the NGPA in 1978, it acted on the understanding that the production market is workably competitive, and that competition among producers would more effectively set prices than the public utility type regulation formerly employed to set wellhead prices. However, Congress also recognized that pipeline companies are monopoly transporters and that continued cost-based control over pipeline rates and control over pipeline practices was essential if consumers were to be protected from monopoly pricing. Without such control, a pipeline could buy gas at a competitive price but resell at a monopoly price and engage in monopolistic discrimination, thereby capturing monopoly rents. Thus, although Congress restricted somewhat FERC's authority to directly review the reasonableness of pipeline's purchases to avoid "back-door regulation" of producers prices, it left to FERC broad authority under the Natural Gas Act ("NGA") to regulate pipeline rates (that is, the charge for transporting gas, rather than the cost of the gas itself) and pipeline transportation and sales practices in the anticipation that FERC would use this remaining authority over pipelines to protect consumers.[5/]

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[2] See, e.g., Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

[3] Sec. 601(a)(1)(A) of the NGPA, 15 U.S.C. § 3431(a)(1)(A) (1982).

[4] Secs. 101-110 of the NGPA, 15 U.S.C. § 3301-3310 (1982) (prescribing price ceilings) and sec. 121 of the NGPA, 15 U.S.C. § 3331 (1982) (providing for removal of ceilings of various categories of gas in 1979, 1985 and 1987); price ceilings on a relatively small amount of gas continue until January 1, 1987.

During the period 1983 - 1985, the ceiling prices for all significant categories of post-1977 gas were well above market levels for gas as determined by the energy-equivalent price of fuel oil, a major competing energy form, and by what arms-length buyers and sellers were currently contracting for. And, while market forces, rather than the statutory _ceilings_, should have dictated the price of deregulated gas, provisions in many contracts between pipelines and producers signed during the period 1979-1981 called for sharply higher prices, usually at NGPA ceil-

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[5/] _See_ Tennessee Gas Pipeline Co., 21 FERC (CCH) ¶ 61,004 (1982).

ing prices, which include monthly automatic price escalation without regard to market conditions. In addition, a number of pipelines purchased deregulated gas on which ceilings were lifted in 1979 at prices of up to three times the ceiling price then applicable to most new gas.[6] As a result, between 1981 and 1983, gas prices more than tripled and demand slackened.

This slackened demand created another problem because many pipeline-producer contracts obligated pipelines to "take or pay" at historically unheard of levels of 75 to 90 percent of the annual production level. A "take-or pay" level refers to the percentage of gas which is capable of delivery in a given year for which a pipeline is obligated to pay currently without regard to market requirements and storage capability. The reduced demand contributed to a surplus of current deliverability; the "take or pay" clauses, if honored, according to their terms would have resulted in costly prepayment obligations for gas not taken and would have caused very serious loss of markets.

Responding to these conditions, some pipelines reduced purchase levels of gas under older contracts which had lower take-or-pay percentages (and usually lower contract prices) to avoid incurring liability for prepayments under newer contracts which had higher take-or-pay percentages (and usually higher contract prices). This action increased average gas costs even further, caused demand to slacken further, and increased exposure to prepayment liability. At the same time, contract prices mechanically escalated higher each month; demand steadily fell.

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[6] DOE/EIA-0440, Recent Market Activities of Major Interstate Pipeline Companies (January 1984) at 12.

In 1983, the average accounting costs for several pipelines for gas purchases escalated well beyond the point at which the price of gas could compete with No. 6 (residual) fuel oil. Since 30 percent of the national gas market is for uses which could be met by No. 6 fuel oil, pipelines faced a substantial competitive marketing threat. Indeed, pipelines began losing their non-captive customers: those customers that could switch to alternative fuels, such as No. 6 fuel oil or to other, cheaper sources of gas.

The pipelines, however, could hardly be considered innocent bystanders victimized by the increases in gas prices caused by third parties. Rather, the pipelines are both the responsible contracting parties and the direct beneficiaries of these soaring prices. Most major pipelines are vertically integrated with gas producers. These producers have thrived from their ability to sell gas to affiliated pipelines at greatly increased prices which the pipelines automatically pass through to consumers without regulatory scrutiny.

The potential for abuse arising from the pipeline's backward vertical integration is clear. In 1982, in stating the enforcement policy of the Antitrust Division with respect to pipeline mergers and acquisitions, the Deputy Assistant Attorney General for Antitrust described the anticompetitive potential from vertical integration as follows:

> Acquisitions by natural gas pipelines are of concern because they provide an opportunity to evade the effects of regulation of the pipeline's rates. In other words, they may allow the pipeline to extract monopoly profits and concomitantly reduce supply and thus cause resource misallocation -- results that regulation, properly directed, is intended to prevent. This is most easily seen in the case of backward vertical integration by a pipeline into production of natural gas. If a pipeline's transportation facilities are subject to effective rate regulation, but no effective regulatory check exists over the price it pays for gas from its own production operations, the pipeline would be able artificially to inflate the price it pays for its own gas. This will raise the rate-regulated pipeline's accounting costs, which the pipeline passes on to consumers. These additional "costs" will be additional profits to the pipeline's production arm and to the firm as a whole.[7/]

Nevertheless, when it first appeared that pipelines actually might lose sales because their gas prices rose so high as to induce fuel switching by non-captive consumers, the Commission not only refused to apply a policy requiring competition and thereby forcing pipelines to lower natural gas prices, but also abandoned all efforts to restrain pipelines from charging monopoly prices and from collecting monopoly rents on their own production from their captive consumers.

Instead, it issued Order Nos. 234-B and 319 (the blanket certificate program) and subsequently the Special Marketing

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[7/] Remarks of Ronald G. Carr, Deputy Assistant Attorney General, before the American Gas Association (March 31, 1982) at 4, reprinted in Public Utility Holding Company Act Amendments; Hearings on S.1869. S.1870, and S.1871, before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 97th Cong., 2d Sess., 350-54 (1982) See also R.J. Pierce, Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry, 97 Harv. L. Rev. 345, 365 (1983).

Program Order, which fundamentally restructured the manner in which gas was marketed. These transportation programs for the first time permitted pipelines to broker their system supply gas to non-captive consumers at prices below those charged captive consumers. They provided that when a pipeline's gas cost rose above a competitive level resulting in lost sales, the pipeline could release gas from its system supply and then arrange for the fuel-switching consumer to pay a lower competitive price directly to the producers. They thereby permitted a pipeline to evade any sanction for paying excessive prices for gas to affiliated or other producers. If a consumer was capable of fuel-switching, the Order allowed the pipeline to transport lower-priced gas to that consumer, while the pipeline -- and indirectly, its affiliated producer -- reaped the full benefits of monopoly pricing from captive consumers having no short-term fuel alternative.

The Maryland People's Counsel challenged these Orders in the United States Court of Appeals for the District of Columbia Circuit on the ground that they were discriminatory and otherwise anticompetitive, and in two opinions[8/] issued May 10, 1985, that Court vacated the challenged orders "to the extent that they allow transportation of direct-sale gas to fuel-switchable, non-'high-priority' end-users without requiring pipelines to furnish the same service to LDCs and captive consumers on non-discriminatory

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[8/] Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C.Cir. 1985); ("MPC I"); Maryland People's Counsel v. FERC, 761 F.2d 780 (D.C.Cir. 1985) ("MPC II").

terms."[9] In doing so, the Court found that pipelines could hide monopoly profits through excessive payments to their own producing arms and generally lacked the spark to engage in the unpleasant business of renegotiating long-term contracts with producers. The Court concluded that discriminatory transportation removed any incentive that pipelines might have to constrain the prices of their own gas supply to customers that were ineligible to obtain transportation access to other sources of gas. The Court also specifically held that by its Orders, the Commission had not attended to its prime constituency -- the consumers whom Congress determined in the NGA should be protected from exploitation at the hands of natural gas companies and had instead created perfect vehicles for pipelines to achieve such exploitation.[10]

On May 30, 1985, the Commission proposed changes to its regulation of transportation services by natural gas pipelines. On October 9, 1985, through Order No. 436, the Commission issued its final rule to comply with the NGA, the NGPA and the mandate of the Court of Appeals in the Maryland People's Counsel cases.

What Order No. 436 Does

In Order No. 436, the Commission promulgated a regulatory framework to replace the discriminatory SMP and blanket certificate programs struck down in the Maryland People's Counsel cases; non-discriminatory access to transportation services constitutes the cornerstone of Order No. 436.[11] In general, it thus can be said that the Order does address the flaws affecting the previous programs and the Commission's rationale in fact demonstrates the virtues and the necessity under the NGA of providing LDCs and captive consumers with non-discriminatory access to market-priced gas offered by producers. Provision of transportation services on a non-discriminatory basis not only assures that the benefits of competitively-priced gas supplies and transmission services are made available to the broadest number of consumers, but also helps to maximize natural gas production and pipeline throughput.[12] All this contributes to the efficient allocation of resources and to the health of the American economy. The Commission found that only through nondiscriminatory transportation could monopoly pricing be eliminated, a practice that FERC found had resulted in wasteful expenditures by gas consumers for equipment to burn other energy forms, and had shut-in independent producers that wished to sell gas at competitive prices.

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[9] MPC II, 761 F.2d at 789.

[10] Id. at 781.

While the Commission provided for non-discriminatory access to transportation services, it bears emphasizing that the Commission did not require the pipelines to provide such services in the first place. Rather, the decision as to whether to provide such services lies exclusively with the pipelines. The pipeline will have two choices: either cut its gas costs to all consumers by enough to keep the fuel-switchable consumers as *sales* customers or provide transportation to both fuel-switchable consumers and LDCs, thereby opening markets to competition that will achieve the same result. Should a pipeline wish to utilize its system to provide transportation services, then it must do so on a non-discriminatory basis and otherwise in conformance with the requirements of the final rule. The Commission also concluded that the mandate of the Maryland People's Counsel case and the Natural Gas Act of 1938 required that it provide for more than non-discriminatory access to transportation in theory; access to transportation services must be meaningful access for all natural gas consumers.

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[11] *See* Order No. 436, IV.A.1.

[12] *Id.*

Natural gas customers are classified into two categories: firm or interruptible. Interruptible customers have the ability to switch fuel sources, *e.g.*, to fuel oil or to another source of natural gas -- and thus contract for service with a pipeline that can be interrupted. Under such a contract, a pipeline does not have to stand ready each day to sell a certain amount of gas to that customer. In contrast, a firm customer, such as a local distribution company, cannot switch fuel sources, and thus, the typical firm delivery contract between customer and pipeline obligates the pipeline to be ready to deliver a certain amount of gas each day. This amount is called the contract demand ("CD").

Thus far pipelines have said to the firm customers: The only gas I will deliver is gas that I sell; if you buy gas from anyone else, I will refuse to transport it on a firm basis.

FERC, therefore, took two steps to stop this anticompetitive tying of delivery service to gas sales. First, over a four-year transition period commencing April 1986, each LDC can elect to use 25 percent per year of its firm capacity to receive gas purchased from anyone they choose -- either the pipeline or independent producers and resellers.

Second, FERC acted to provide firm transportation capacity for those that are not now customers. While pipelines may have considerable capacity to transport gas on an interruptible basis, the firm capacity of most pipelines is generally contracted for, although with the reduced demands for natural gas in recent years, the levels contracted for by firm customers may be greater than their needs.[13] Thus, a firm sales customer seeking firm transportation services from its pipeline generally cannot obtain such service unless firm capacity on that system can be "freed up." The Commission provided for such freeing up of capacity by granting to firm customers an option to reduce their contract demand by 25 percent each year for four years beginning in 1986. In this way, a firm sales customer no longer having the same requirements for natural gas as provided for in its contract demand can adjust its reserved capacity to its actual demand for gas, thereby freeing up pipeline transmission capacity that can be made available to those who actually require it.

In making these changes, FERC provided that pipeline companies would earn the same revenues on transportation that they earn now. The pipelines' insinuations to the contrary are discussed below.

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[13] Order No. 436 IV.A.70.

The Pipeline's Complaints About Order No. 436 Are Specious

The pipelines have come before you and seized upon the reduction and conversion options, described above, and argued that the access to independent producers provided to firm customers by these options abrogate existing pipeline/customer contracts. Any such abrogation, the pipelines claim, will result in ruinous increases in take-or-pay liability under their contracts with producers. These arguments are specious. The pipelines' claims of (i) contract abrogation, and (ii) ruinous take-or-pay liability are spurious.

Pipelines' Contracts Have Not Been Abrogated

First of all, the pipelines' claim that their contracts have been unlawfully abrogated is untrue. Firm customers do not presently have any obligation to accept delivery or to pay for any gas with respect to their CD amounts; these customers are not obligated to purchase even one cubic foot of gas from the pipelines or to pay any amount for the cost of gas which they do not actually take. A firm customer, however, must pay the portion of the pipeline's fixed costs attributable to its contract demand amount whether it buys any gas or not. In other words, the only contractual obligation for such customers is to pay for transmission capacity that is reserved for their use.

Order No. 436 does not affect this obligation of firm customers to pipelines. It will not prevent pipelines from recovering these fixed costs. For example, the conversion option only allows firm sales customers to use a portion of their CD entitlements, for which they pay the full fixed cost, to transport gas that is purchased from sources other than the pipeline. The customer would still be using the pipeline to transport the same CD amount of gas, and its obligation to pay the pipeline will be unchanged. The conversion provision would not reduce the utilization of the pipeline; and, apart from utilization, it would require that the customer pay the same amount of fixed costs regardless of use. Thus, customers would continue to share in the pipeline's fixed costs precisely to the same degree as they would have done if they had not exercised the conversion option.

Similarly, while the CD reduction option is somewhat different in that it would allow firm customers to reduce their contract demand for all forms of service, rather than merely to convert that demand to unbundled transportation services, the pipeline still is not prevented from recovering the fixed costs which by contract with its customers it expects to recover. Again, the major purpose of the CD reduction option is to allow a freeing up of unused (misallocated) capacity that existing customers previously have reserved but no longer desire to use. This freed up capacity is available to be sold by the pipeline on a firm basis to other customers for sales or transportation services; from these customers the pipeline will be able to recover those costs associated with the contract demand that has been reduced. To the extent that the pipeline, for some reason, cannot market this freed up capacity to other customers to offset a reduction in contract demand, the pipeline still can recover its fixed costs to the same extent as before the reduction occurred by simply filing a rate case to reallocate the difference over all firm sales and transportation services. Thus, if the fixed costs of a pipeline are $500 million, and it has projected sales and transportation volumes of 1 billion dekatherms of gas, the rate will be set by dividing $500 million by 1 billion units. But if CD reductions bring volumes down to 800 billion dekatherms, the new rate will be set by dividing the same $500 million of fixed costs (which includes profit) by 800 billion. The rates will be higher, but the revenue to the pipelines is still $500 million.

In summary, under the present framework, pipelines can expect to continue to recover the same level of fixed costs attributable to present contract demand; under Order No. 436, their ability to recover such costs is in no way altered, abrogated or diminished.

The Pipelines' Claims of Ruinous Take-or-pay Liability Is Without Foundation

The pipeline's claims of ruinous take-or-pay liability as a result of the non-discrimination requirements of Order 436 are similarly specious.

Where competition exists, pipelines are now actively renegotiating a portion of their above-market-priced wellhead contracts to market-clearing levels, without undue hardship to pipelines. Indeed, pipelines have been successful in buying out their contracts for $.10 to $.15 on the dollar;[14] and while the pipelines have speculated that their total take-or-pay exposure is as high $7 to $10 billion, actual take-or-pay prepayments sought to be recovered in rate cases have been less than 1 billion and have been decreasing over the last three years.[15] In this regard, the U.S. Department of Energy has reported that renegotiation of pipeline/producer contracts, together with the exercise of market out clauses, "have eliminated most of the problems with existing pre-payment liabilities and take requirements that have been reported by natural gas pipeline companies."[16]

We agree with pipelines that the process of renegotiation will intensify as a result of Order No. 436. While pipelines have met with considerable success in renegotiating contracts with producers to date, the possibilities for increased competition under Order No. 436 will cause the pipelines to exert even more pressure on their suppliers to lower prices to a market level in order to sell the gas. For example, the U.S. Department of Energy found that the pipelines' ability to frustrate competition in the sale of natural gas in their markets has reduced their incentives to press for lower prices in renegotiations with producers. Only in end-user markets where there has been clear competition from alternative fuel sources (and the ability to use these sources) have pipelines actively sought to lower prices to those customers able to switch to alternative sources of supply. Because of Order No. 436's non-discrimination requirement, competition will spread to captive markets (those markets where alternative fuels are not available), thereby creating competition on pipelines in all markets, not just fuel-switchable markets, and increasing the pressure on them to renegotiate production contracts. It is perhaps by no means a coincidence that approximately one month after the terms of Order No. 436 were made public, Columbia Gas Transmission Company successfully concluded renegotiation of certain of its contracts that were at above market prices with four of five of its principal suppliers, all major oil companies. Because the CD conversion option will increase the pressure on the big producers, the major oil companies, they, too, oppose truly nondiscriminatory access).

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[14] U.S. Dept. of Energy, Increasing Competition in the Natural Gas Market: the Second Report Required by Section 123 of the Natural Gas Policy Act of 1978 64 (Jan. 1985) ("Second DOE Report").

[15] Order No. 436, IV.A.46-47.

[16] Second DOE Report at 57.

Uncertainty about how the Commission would deal with the current problems in the natural gas market had impeded formal renegotiation of producer contracts. Order No. 436 was designed to, and in large measure does, lay to rest much of this uncertainty. Consequently, incentives to renegotiate will increase even further as a result of Order No. 436, not only on the part of the pipelines but also producers. Historically, producers could not sell their gas directly to end-users because they did not have access to transportation. Under Order No. 436, independent producers which are already willing to reduce their prices, but which nonetheless have been shut-in, will gain access to markets that the major oil companies want as their exclusive preserve. This will increase "liabilities" only in the sense that if consumers are not paying the above-market prices, there will be a contract claim for the difference between the contract price and the market price. The gas will still be saleable -- just at a lower price.

Therefore, the take-or-pay obligation rarely results in actual payments on the part of the pipelines, since, when the gas is released by the pipeline for sale to another buyer, the producer usually waives any contract claim. Where pipelines have encountered contract claims for the difference between contract and market prices, they generally have been settled at $.10 to $.15 on the dollar. These settlements have been documented by FERC and DOE as discussed previously.

Finally, to the extent that take-or-pay liability increases as a result of Order No. 436, the Commission has provided the pipelines with the means to recover such costs. For example, if a pipeline does incur take-or-pay expense in connection with a contract dispute, and such expense meets the standard of prudency, it can be recovered in the pipeline's rates.

The Pipelines' Real Purpose

As can be seen, there is now no compelling need for legislative intervention to recast pipeline-producer contracts that pipelines freely negotiated, or to upset the administrative process. Why then have the pipelines come to Congress? What is the controversy really about?

First, the pipelines have come to Congress to seek legislation so that they can avoid effective rate regulation. When purchasing high-priced gas years ago, the pipelines were not relying on some perceived contractual obligations of consumers to take all the gas that the pipelines could contract for with producers, including their own affiliates, no matter what the price. Rather, the pipelines relied on the perception that regulation would permit them to pass through to consumers the cost of gas even if the cost was above market-price; they relied on a perceived weakness on the part of the Commission in dealing with the pipelines' abuses of their monopoly power. The pipelines had no legitimate right to expect such a result, and in Order No. 436, the Commission disabused the pipelines of the notion that their monopoly would go unchecked by effective rate regulation.

The pipelines also desire to avoid prudency reviews of their gas purchasing practices. As I noted earlier, take-or-pay expenses are recoverable through rate filings to the extent that they were prudently incurred. When the pipelines state to you that their take-or-pay liabilities will go unrecovered, they are admitting the imprudency of their gas-buying practices, since FERC has said they can recover any prudently incurred expense.

In addition, the pipelines have come to you because they wish to continue to engage in the patently anticompetitive practices that the Court of Appeals struck down in the Maryland

People's Counsel cases. As the Court noted, the old transportation programs provided the perfect pricing tool for a profit-maximizing monopolist. Under these programs, pipelines could transport producers' reasonably-priced gas to fuel-switchable end-users, thus dissuading those users from turning to fuel oil and other alternative energy sources; at the same time, the pipelines refused to provide the same service to, and instead collected monopoly rents from, captive customers. The old programs were, in effect, a safety valve for pipelines to bleed off the accumulated pressures they faced in certain of their markets.

This marketing tool was particularly useful for pipeline monopolists which were vertically-integrated backward into production (as are virtually all major pipelines). By utilizing discriminatory transportation programs, these pipelines could assure a market for their affiliate's high priced gas, and thus assure to themselves the excessive profits from the sale of such gas to the pipeline's captive customers, e.g., local distribution companies and eventually residential consumers and small businesses.

As is true in monopolistic markets generally, these programs have cost consumers billions of dollars in excessive energy costs, and resulted generally in a gross misallocation of resources, including, by way of example, consumers' turning to installation of costly wood-burning stoves and expensive, electric heat pumps. The pipelines, therefore, have come to you to obtain legislation which will ensure that they will continue to reap excessive profits from consumers and which will guarantee that the gross misallocation of this country's resources as a result of high gas prices will continue indefinitely as Congress once again tackles the divisive "gas issue" without resolution.

Conclusion

The key point is that the market pressures that Order No. 436 seeks to restore are healthy. They are the stimulus essential to power the transition to competitive levels of gas costs. The transition is essential to the future vitality of all segments of the industry, to the avoidance of economic waste, and to increasing the vitality and competitiveness of American industry. Change of this kind is the everyday stuff of commerce. For example, labor pacts have been renegotiated in the automotive and airline industries to meet foreign and domestic competition. There is no reason to exempt monopolistic pipelines from the belt-tightening that businesses and labor are undertaking in other sections of the economy. The pipelines simply have not shown a compelling need for legislation to recast their contracts with producers and to return to the discriminatory and anticompetitive practices that are now injuring the 75 percent of the consumers and the thousands of independent producers that have been shut out of the competitive marketplace.

Senator NICKLES. Mr. Legato, I'm glad that you and Dr. Cooper have proven that this was not a unanimous panel. [Laughter.]

We also have an additional panel, and I wish we had several more hours, but as you know we are on the floor and we're debating.

I would like to ask just a couple of questions, primarily for the pipeline panel, and then I'll ask a couple of questions to our others. I heard several——

Senator BRADLEY. I only heard one—I only heard Mr. Legato, and I'd like to hear the other side make the argument. I liked what I heard from Mr. Legato, but I would like to have the other side have a chance.

Senator NICKLES. I'll make that my first question. Mr. Morgan, Mr. O'Neill, or Mr. King, would you like to give the counterside to what Mr. Legato said?

Mr. KING. Well, I'll speak for my own company, Colorado Interstate Gas Co., Senator. On March 28, we filed new tariffs—March 28 of this year—we filed new tariffs with the Commission providing for completely open transportation for everyone. This was prior to the filing of the NOPR or any of the things we're discussing now.

To this date, the Commission has taken no action whatsoever on those filings.

So far as the prudency of our gas purchases is concerned, they've been examined in all of our PGA's of recent years, and we've been given a clean bill of health. I simply don't recognize my company or the industry in the allegations—in Mr. Legato's allegations.

Senator NICKLES. Let me just ask a couple of quick questions.

Mr. Smith, I believe your company is the only company that is actually participating right now. Is that correct? Is any other company participating?

Mr. KING. No, sir; we are also——

Senator NICKLES. Colorado Interstate, as well?

Mr. KING. Yes.

Senator NICKLES. Is Colorado Interstate, Mr. King, are they going to be participating after December 15?

Mr. KING. No, sir; we don't intend to.

Senator NICKLES. Representing INGA—Mr. Smith already mentioned that American Natural would not be participating after December 15. Is that correct?

Mr. SMITH. That is correct.

Senator NICKLES. Do you anticipate—or how many pipelines do you anticipate participating after December 15 if the rule is not modified?

Mr. KING. We don't know, and we have not asked our pipeline members.

Senator NICKLES. Would my assumption be correct that of the major interstate pipeline systems it would probably be one or two, if any?

Mr. KING. I don't know. I'm aware of only two companies that have announced that they intend to participate after December 15.

Mr. TERPSTRA. Mr. Chairman, I think it's fair to say that we're waiting for each company to make an announcement. It would be inappropriate for us to discuss that with the other companies—at least in my case, we certainly do not discuss that.

Senator NICKLES. The other companies, though, that have testified have indicated—correct me if I'm wrong—that they do not plan on participating in the transportation rule after December 15. Is that correct, Mr. O'Neill, for Transco?

[Mr. O'Neill nods in the affirmative.]

Senator NICKLES. Southern Natural?

[Mr. Morgan nods in the affirmative.]

Senator NICKLES. Midcon?

[Mr. Terpstra nods in the affirmative.]

Senator NICKLES. In your opinion, what changes could and should be made to the transportation provisions of 436 in order to entice pipelines to participate? I'll just start down the line.

Mr. KING. Well, I would say, No. 1, that we've had an evolution that is growing every day toward more and more transportation; that the way this should be handled is as its developing now where each of us individual companies proposes a method to achieve nondiscriminatory access for transportation to our systems.

Order 436 is a regulatory rats nest. It is going to result in underutilization of our systems, and uneconomic use of them; it simply does not fit the transportation needs of the consumers of this country.

Senator NICKLES. I'm going to try and hone in. I'm also going to be testifying before the Commission. I'm looking for some recommendations of changes, if any. I'll just ask any of the other pipeline representatives: If they eliminated the 25-percent-contract-demand reduction, would that encourage your participation in the transportation provision?

Mr. MORGAN. Let me—may I speak, Senator Nickles?

Senator NICKLES. Certainly.

Mr. MORGAN. From our point of view, the overriding thing here is take-or-pay. There's no question about the significant, the major significant thing is trying to give us some balance. They deregulated the market end of our pipeline in 436, but here we've got straitjacket contracts with our producers which we got because we are obligated to have gas supply to serve our certificated requirements.

Now give us some help on that end so that we can renegotiate those provisions and make it an even playing field. At the very least, sir, Senator Nickles, if a pipeline is to utilize 436, at least provide that a producer that wants to have its gas put in the pipeline for transportation to market would at least have to agree to renegotiate the take-or-pay provisions in these contracts to reflect current market conditions.

This is a brandnew game. The most revolutionary changes we've ever seen in the natural gas industry have taken place right now, as Senator Metzenbaum said, and you can't just make them take place at one end of the system and ignore the other end, which is what the FERC has done. That's the way we look at it at Southern Natural.

Senator NICKLES. So your recommendation would be that if a producer is participating, that as a condition for his participation as far as free access would be a take-or-pay reduction or abrogation of that contract?

Mr. MORGAN. To reflect take or pay—to reflect current conditions in the take-or-pay provisions of our contract, our long-term contract.

Senator NICKLES. Mr. Morgan, does that include old contracts, as well?

Mr. MORGAN. Yes, sir.

Senator NICKLES. So you're willing——

Mr. MORGAN. But the take or pay—in all candor, Senator Nickles, the take-or-pay problem really doesn't have——

Senator NICKLES. I know it doesn't apply, but what you're basically saying is you want to abrogate contracts that "are above the market today." Do you want to change those contracts that are below the market today, at the same time?

Mr. MORGAN. All I need, when you say "abrogate" let me just say this, Senator Nickles. I've entered into a group of contracts with provisions that are based on my having a gas supply to serve certificated requirements.

We've entered into long-term gas supply contracts, some of which are old, but the problem contracts are the new contracts to meet the certificated market requirements that we're supposed to serve under the Natural Gas Act that have been certificated to us.

If the supply—if the market end of our pipeline is going to be totally deregulated so that those requirements are going to be served through transportation programs, if distributors are going to reduce contract entitlements and so forth, all I want is some mechanism to balance my obligations at the other end that I have with the producers, some mechanism to balance the gas that I agreed to take to meet the market that now has been deregulated and gone elsewhere.

Senator NICKLES. I just want you to know that I and many members in this committee have a hard time—and I have a real hard time—with the 25-percent marketout, but I also have a real hard time with you coming in and saying we want to abrogate take or pays. Contract sanctity does happen to mean something.

I heard Mr. O'Neill mention deregulation. I've heard Mr. Terpstra before this committee mention deregulation before, too. But I think we need some consistency. And I don't want—or I personally wouldn't agree with the idea that, well, we'll just abrogate some and not abrogate others. I personally think abrogation mandated either by FERC, which personally I don't think they have the statutory authority to do so, or second, I think Congress if they did so, would be making a very serious mistake.

Mr. MORGAN. Let me say one thing before turning this over to Brian O'Neill. If I said something that indicated to you that we wouldn't support wellhead deregulation, then I misspoke myself. We'd support that, and we supported it before. We were one of the pipelines that supported it before, Senator.

Senator NICKLES. Good. Mr. O'Neill?

Mr. O'NEILL. I'd echo that, Senator, that we certainly are in favor of deregulating the old gas, all gas as a matter of fact, and have consistently taken that position not just when the price was low now, but in other times also. I think the market ought to work.

We also are very much an advocate of transportation. We believe that our pipeline is a transporter, and we're very much in favor of trying to get open access. But we've got to do something other than to just put our whole pipeline up with its net worth on the line as a way of handling it. I just don't think that's the way we can go forward.

Senator **Nickles**. Mr. Legato mentioned that the FERC's rule would not involve massive contract abrogation.

Do you agree with that? Would that change your contracts, or not?

Mr. **Terpstra**. Part of the problem I feel is that we need a transition. What we're really saying is, we're willing to be transporters, but we need a transition. The current regulatory environment is a maize of contracts. There's contracts at both ends of the pipeline.

We built a supply to satisfy our entire markets without transportation being a factor. It wasn't, until a couple of years ago. Now we're being asked to make room for that transportation. We're willing to do it, but we must resolve our contractual obligations at the other end of the pipeline.

The concern we have on the 25-percent reduction, if that were removed, is that we believe it would be very financially advantageous for a number of our customers to merely pay that demand charge. And then when it gets cold and they lose spot gas, they'd come back and expect us to then have that. Our demand charge is not that expensive, and we would be faced with trying to serve two masters: one shedding supply to get balance between our supplies and our markets; but on the other hand, being in a position when it gets 20 degrees below zero, which it does get in Chicago, or at least it gets down to zero every year a few times, they'd come back entirely to us. And one of our major customers has in fact said that. They were quoted earlier this year as saying we're going to buy a lot of spot, but when it gets cold, the quote we have is, "As winter goes on, we fully expect we wouldn't get the quantities we're getting now," and that's referring to spot gas, "but we're counting on some deliveries in the winter. We'll fall back on the pipeline suppliers for the full contract volume on the days we have to."

We can't exist in that kind of an environment when we're very low deliveries on certain days, and then they want full contract on the others. So we have to begin to balance, and we need a transition. Tell us what you want. Tell us how much you want us to be a merchant. Tell us how much you want us to be a transporter. Then let's adjust the contracts to get there on both ends of the pipeline.

Senator **Nickles**. Senator Ford, did you have any questions or comments?

Senator **Ford**. I wish to pass to Senator Bradley. He has to leave. I'll be glad to yield my position to him.

Senator **Bradley**. I thank you, Senator Ford.

I'd like for Mr. O'Neill and Mr. Terpstra to essentially respond to the points that Mr. Legato made. One is on the question of obligation to serve, which is what you addressed, I think, Mr. Terpstra, in the last answer. He says FERC releases you from that obligation to serve.

Mr. Legato, if you find that at some point you want to rebut, please do. And I'd like to compliment the chairman for setting up this kind of debate, which is extremely helpful.

Mr. Terpstra, do you want to respond to that, and then Mr. O'Neill, and then Mr. Legato?

Mr. **Terpstra**. I think if you would contact our customers, you would find that they believe I have an obligation to serve. I have a contract with them that extends through 1990 at Natural Gas Pipeline, which specifies certain amounts. Right now, they have nominated in the year I'm in that I have an obligation to try to deliver up to just over 1 trillion cubic feet of gas. My deliveries are going to be appreciably under that.

If a customer decides to shed some of that, then I would not have an obligation for that. But the transition proposed under Order 436 says over the next 4 years, they will periodically tell me what they want me to adjust my supply to. That is very difficult to go through a continual readjustment when we have very little negotiating ability to get that relief from our contracts at the other end of the pipeline.

Senator **Bradley**. Mr. O'Neill?

Mr. **O'Neill**. Yes. Thank you, Senator.

Basically I think there is one thing that is not well understood. That is, under the act—or excuse me, under the order as it's currently constituted, a customer would have the right, on an interruptable basis, to go contract with a third party, and thereby displace the firm supply that he normally would be taking from the pipeline. And he does this without ever having to reduce his commitment to the pipeline, and vice versa.

In other words, he is not required to give up part of his contract as a condition to doing that. So consequently, I would say that I don't see anything that really would reduce our contract demand and our obligation to serve, if you will.

On the other hand, I will also tell you that our customers have indicated they're not particularly interested in giving up their 25 percent per year. They don't particularly want to go out and contract for all these supplies themselves. I think basically the sense we've gotten has been they would like to have a small portion of that perhaps just to play in the spot market with respect to certain loads that could be served, you know, without great trouble if they were not to have the gas.

So, no, I don't agree with that statement at all. And if we don't have the obligation, I would be interested in finding that out.

Senator **Bradley**. Mr. Legato, did you want to comment?

Mr. **Legato**. Senator Bradley, there's something that just doesn't add up here. On the one hand, they tell you that, yes; they agree with me that if the LDC's accept this 25-percent-per-year adjustment, the LDC automatically loses any right to look to the pipeline to supply gas to that extent.

At the same—and they, however, they're concerned about this interruptable problem. But this interruptable problem wouldn't exist if the pipeline industry were willing to accept the 25-percent-per-year reduction, which would give the LDC's the right to get firm transportation service, and they wouldn't have to look to the pipelines to supply that gas.

Now the thing that doesn't add up here is that they have made it—the thing that is the worst evil with this rule is this 25-percent-per-year reduction that also relieves them of the obligation to supply gas. So every one of their testimony says the evil, the disincentive that causes us not to participate in Order 436 is the 25-percent-per-year reduction that also gets us out of any obligation to sell gas. And yet they come to you and say it's the obligation to sell gas that's really the problem, and it's the take or pay.

Mr. KING. Senator, may I respond?

Mr. SMITH. I'd like to respond, if I may——

Senator BRADLEY. Mr. Smith, yes. Fine.

Mr. SMITH [continuing]. Because the principal thrust of what I was trying to say before is that in our system where we have the two separate types of customers—those are partial requirements' customers who can switch to other sources of supply and take advantage of the new rule—when they do that, and when they ratchet down, they will leave uncovered costs, fixed costs, that will also add to our take-or-pay costs. The remaining customers have to pick that up.

As I said before, it's about 50–50 on our system. That will shift a large portion of those costs to the State of Wisconsin, Iowa, and other places, and off of the State of Michigan. That happens to be my home, and I don't want to put it on this regional basis, but that is in fact what will happen. It's a subsidy of one set of customers by another, and that's one of the principal problems with the ratchet down.

Senator BRADLEY. Dr. Cooper?

Dr. MARK COOPER. Let me make one point about the full requirements 'customers in Wisconsin who are stuck on this shrinking system. The full requirements 'customers in Wisconsin get a very important quid pro quo for the risk that somebody else will get off the system. They get the right to go into the gas field and buy the commodity cheaper. So that there are risks and potential rewards.

The assertion here is that we're going to force the fixed costs of the pipelines to be borne by a smaller group of customers, but at the same time those customers who have been prevented because of discriminatory carriage from getting access to gas that's $1, $2, $3, $4, $5 below some of the gas they're being forced to pay for, it's a risk that—we're willing to take that risk.

Senator BRADLEY. So your argument is that, as a consumer, you're willing to take the risk of the higher flow through of fixed costs in exchange for the lower gas price.

Dr. MARK COOPER. An imperfect transportation structure has been conveying imperfections back to the wellhead market which Congress has told us is workably competitive.

Senator BRADLEY. Does anybody want to make a comeback to that? Mr. Terpstra?

Mr. KING. Senator?

Mr. TERPSTRA. Did you want to go first?

Mr. KING. Well, Senator, if I may——

Senator BRADLEY. I want to hear from Mr. Terpstra—

Mr. KING. All right, sir.

Senator BRADLEY [continuing]. Only because I have already heard your answer

Mr. TERPSTRA. Well, first of all, the average price of our gas today is $2.55. If anyone can find it for $3 less, I'd like to find that location.

Senator NICKLES. Is that——

Mr. TERPSTRA. That's our WACOG.

Senator NICKLES. That's your what?

Mr. TERPSTRA. Natural Gas Pipeline's WACOG average purchase price of gas——

Senator NICKLES. Average purchase price.

Mr. TERPSTRA [continuing]. Of $2.55, our selling price, the commodity portion is $2.78. It is not a bad price in comparison to alternative fuels. However, there is spot gas available for less. What I have been trying to say, and I will try to be a little more articulate this time, is that we are concerned that our customers will pay the demand charge and go buy spot gas, and then they will want the right when it's cold or if the spot gas dries up, or the prices turn around in a year or two, to come back and buy our gas for $2.78. And in the interim, we will have a very difficult time living with the take or pay, with honoring our contractual takes, and the like.

What we're saying is, you can't have this freedom at one end of the pipeline and the complexities and maize of contracts at the other.

Senator BRADLEY. The obligation that you express is not a legal obligation, but is an obligation of good customer relations. Isn't that true?

Mr. TERPSTRA. No; I have a contract with my customers where they have a daily right to buy that gas. We have a service agreement with those customers. You're going to have someone on the next panel——

Senator BRADLEY. So you're whipsawed at both ends.

Mr. TERPSTRA. Yes, sir.

Senator FORD. That's the long-term contracts. Are they long-term contracts?

Mr. TERPSTRA. Yes, sir; they are long-term contracts. I believe they were originally of 20 years' duration.

Mr. LEGATO. Senator, these same——

Senator BRADLEY. Last shot, Mr. Legato. [Laughter.]

Mr. LEGATO. This point about being whipsawed, they refer to these long-term contracts under which they have a service obligation to sell gas, and it's these same service obligations under these same contracts that the FERC said are automatically terminated when the distribution company elects to convert from sales to transportation. The pipeline doesn't have to do anything. It's automatic by force of law. The pipeline is off the hook to the same extent the distribution company converts.

Senator BRADLEY. So you're saying there isn't a legal obligation.

Mr. LEGATO. Absolutely, sir. That's correct.

Senator BRADLEY. Well, I'm not a lawyer, and we have—Mr. O'Neill?

Mr. O'NEILL. One last thing. What Mr. Legato is assuming is that the customer automatically exercises his right to reduce the contract 25 percent. The point I was trying to make is that our customers have pretty much indicated they're not particularly interested in doing that; and, instead, they would substitute interruptable spot gas, which they can do without giving up their contract demand, and consequently our contract otherwise stays in full force and effect.

Senator **Bradley**. How would they get the interruptable spot gas?

Mr. O'**Neill**. There's a lot of it out there available. And as a matter of fact, we think one of the things that could well happen is that we could have producers that we would perhaps otherwise be taking normal supplies from that would sell into this spot market.

Senator **Bradley**. But how would they get it? How would they get it into New Jersey?

Mr. O'**Neill**. Through our system, because we would transport that gas. That's correct. And of course even without accepting——

Senator **Bradley**. And would you charge for transporting the gas?

Mr. O'**Neill**. That's correct; we would.

Senator **Bradley**. What would be the difference between the charge that you would have gotten if you were delivering under contract versus what you were getting through the transport of the spot gas?

Mr. O'**Neill**. Let me say on that point, we are essentially indifferent. We are transporting today more gas than we are having purchased from our normal systems supply, Senator. The problem, again, and the thing that predominantly worries us, is the take-or-pay problem. That's the thing that isn't factored in. Enormous take-or-pay accrues as you go through the spot transportation of gas in lieu of taking it from your normal supplies. And that's the problem we think really has to be addressed.

Twenty-five percent really is a problem to us, and I think it has a lot of implications to it. But the really overriding consideration is the take-or-pay problem.

Senator **Bradley**. One last question. What if a pipeline, a competing pipeline in any of your areas, decided to go big into this carrying of essentially renegotiated or contract gas? What would you do? Texas Eastern, for example, decided they were going to become a big contract carrier?

Mr. O'**Neill**. That's one of our favorite competitors, of course, and we've been competing.

Senator **Bradley**. What if they decide they're going to really make this 436 work; they're not going to opt out on December 15, they're going to start to carry big quantities of gas?

Mr. O'**Neill**. At some point in time, as our ability to transport is diminished, let's assume that at 2 years down the road we'll totally be without any ability to transport, we'll be faced, I suppose, with the question of whether we want to put all our net worth up one way or the other. It's just gone. I mean, it's not much of a choice, frankly.

Senator **Bradley**. I don't quite understand.

Mr. O'**Neill**. Well, the problem is that if in fact we elect open access, as we see it the potential liabilities are so enormous—and I tried to point out a specific example—we are barely taking gas above the amount of protected gas we have on our system today from our normal sources. This is drainage, casing head, and well-protection gas. If spot supplies displace all of that, we have enormous potential liabilities in addition to take-or-pay to cope with. And I don't know how that's going to be handled.

I heard the producers say they would negotiate with us. I feel that that's—I appreciate them saying that, but we see billions of dollars of liability in that direction. There's just no incentive to go there. The other side of it is perhaps somebody is able to compete with us more effectively and we lose the market anyway. It's sort of a catch-22 situation.

Senator BRADLEY. Well, the fact is that some of the big companies have really resolved a lot of the take-or-pay problems, 600 or 700 million dollars' worth. Now why should there be additional assistance?

Mr. O'NEILL. You mean big pipeline companies have?

Senator BRADLEY. No. Big——

Mr. O'NEILL. Big producers?

Senator BRADLEY [continuing]. Producers.

Mr. O'NEILL. Let me say that we have had a considerable amount of success on an ongoing basis negotiating with our producers, as we've gone along. In many cases we have—if you will, what's happening here is that the pipeline is trading access to its system in addition, or in exchange rather for take-or-pay relief. That's what's been going on. Now we're talking about access to the system being granted on a nondiscriminatory basis. That ability to negotiate is gone.

Some of the producers, frankly, have been very good about working with us on take-or-pay. Others have been extremely difficult. I just don't know where we would end up in that regard. We'd have no leverage at all to deal with the producer any longer.

Senator BRADLEY. Thank you very much, Mr. Chairman. I thought it was a productive exchange.

Senator NICKLES. Thank you, Senator Bradley.

Senator Ford, did you have any——

Senator BRADLEY. And I thank Senator Ford.

Senator FORD. Mr. Legato, are you in favor of deregulating old gas?

Mr. LEGATO. The position of NASUCA is——

Senator FORD. What?

Mr. LEGATO. The position of NASUCA is opposed to deregulation of old gas.

Senator FORD. Why are you opposed to deregulation of old gas?

Mr. LEGATO. The Congress in 1978 reached a historic compromise after 2 years of vigorous debate. During that debate, it was determined that all newly discovered gas would be deregulated, and the old gas would not be deregulated. That was the compromise then. We think the basis for that compromise still exists. What the Congress decided, at least in the compromise, was that the rents on old gas, the difference between the market value of gas and the cost to the producer including profit of developing that gas, should be captured for the benefits of consumers; whereas, with respect to new gas supplies, the free market should determine the quantity of gas to be discovered and the price that would be paid for that gas. And we don't see any reason to upset that compromise.

Senator FORD. Are you going to oppose the Secretary of Energy's proposal that they raise the price of old gas?

Mr. LEGATO. Yes, Senator Ford, because it is in our view not lawful for the Commission to adjust the previously established just and reasonable prices to a market price. They are restricted under the Natural Gas Act to set the just and reasonable level at a cost-based price, and there's no basis for setting it at a market price under the applicable court decisions.

Senator **Ford**. Well, I thank you for substantiating the position of the Federal Energy Regulatory Commission on its block 2 position.

Take and pay bothers me a little bit. I see business becoming whipping boys here because of the problem of the times. I can see everybody running to Congress and saying, leave it alone; we've got a good deal, and let the others squeal. Somehow or another, what's fair for the goose ought to be fair for the gander. I'm inclined to agree with the pipelines that they're getting relief on the other end. When we see that block two is being substantiated by those who are saying put it to the pipelines, that bothers me considerably.

I can't find the fairness. I know the producers, some of them are working out take or pay and some are not. Mr. Eck awhile ago said they worked out Columbia Gas. Well, I say to you, if you didn't hear me, that Columbia Gas threw all its assets on the table and Amoco and the other producer took them all. [Laughter.]

So that was just absolutely breaking or taking all the assets of the pipeline. That's take and pay. [Laughter.]

Something about it just bothers me considerably, and I'm not sure I can put my finger on it. I understand you want to give the consumer the best prices possible. There's always a culprit out there somewhere, and you can always jump on a culprit. But you're not operating a pipeline, and you're not out there drilling wells trying to recover natural gas, and I see the same problem here as I find in the coal field.

I don't see anybody down there helping us with the Staggers Act. I don't see anybody trying to reduce—and you frown a little bit, you know, you probably don't even know what the problem is.

Mr. **Legato**. Oh, I do. I do, Senator.

Senator **Ford**. But it's all relevant; it's all energy. We're all trying to work in the same direction.

Mr. Chairman, I'm not going to take any more time, but I'm going to dig into this a little bit more, and I'm going to try to see if I can come up with something in my own mind of a hard, firm position.

I understand the producers. I understand them very well. It's dollars. I understand the pipeline very well. It's dollars. I understand the consumer very well. That's dollars. And so it's all what it costs. If times were good and everybody was making a lot of money and we had 3 or 4 percent unemployment, you probably wouldn't be here. But under the circumstances, we've got an 80-percent industrial production out there, and we're not doing very well, and a very large percent of our short-term goods is manufactured overseas.

In fact, I even talked to one of my discount managers the other day. They're having the price of imports stamped in: regular price $6.50, our price $4.75. You don't even have to hire an American to change the stamp; put it on the underwear.

So I understand what's out there. I understand a great deal of it.

Mr. Morgan, you seem to be one who brought the take-or-pay, and maybe others, but I'll ask this one question and then I'll quit. In your statement as I read it and as I listened to you, because you took it right off the top of your head, so I suspect you understand very well what you're talking about, that you have not achieved the success you would like with your take-or-pay negotiations. And you have requested FERC and this committee to address this problem.

Now do you have specific recommendations for FERC or for this committee as we try to proceed down this path? I've been here 11 years now, and I went through the Natural Gas Policy Act. I voted on Christmas Eve on what then was referred to as a turkey. [Laughter.]

But I gave my word at 2 a.m. in the morning, and I don't break it at 10 a.m. the same day. So I've been through all these frustrations, and I don't want to get into it again. I see those wanting to do lots of things, but hold onto the regulated gas price. Maybe you just want to bust it all loose and let them get out there and scratch for their own and then you'd be out of business and they'd be trying to get it.

So, Mr. Morgan, explain to me what specific recommendations you'd like to have.

Mr. MORGAN. Senator Ford, with reference to this committee, if this committee is thinking about legislation we would support the position of broad-based legislation that would have total deregulation at the wellhead, transportation provisions that make it clear we're going to have open access transportation on pipelines, provisions that do away with the Fuel Use Act, and provisions that do away with the incremental pricing provisions that are in the old NGPA of 1978. Broad legislation that brings us up to date on where we are.

Insofar as the FERC is concerned, sir, on opinion 436, if that's what I'm looking at, Senator Nickles said he was going to testify before the FERC. Really what the most I think I could ask for there is at least provide, Mr. FERC, that if a producer wants to utilize a pipeline system for open access transporation under order 436, he will at least agree to adjust the take-or-pay provisions in his contracts to reflect market conditions.

We've got producers suing us today under take-or-pay provisions who, if it were open access, if we were under 436, they would put additional gas into our pipeline system for transportion so that it would further displace system sales and aggrevate my failure to live up to my existing take-or-pay provisions.

I've got that situation. I'm there; 436 makes it impossible, unless I get some help.

Senator FORD. Thank you, Mr. Chairman.

Senator NICKLES. Thank you, Senator Ford. I think you made some good comments, and I look forward to working with you.

I'm going to follow up, Mr. Morgan, on that same question.

Mr. O'Neill, you mentioned that one of the things that you have to get a producer to make some adjustments on take-or-pays is to give them access. When you talk about adjustments or a tradeoff, are you talking about adjusting every take-or-pay contract they happen to have with you? Or would it be a comparable volume that you're looking at? In other words, if you would move so many thousand cubic feet of gas for them, that they would adjust a corresponding amount of take-or-pay in some type of a ratio, or something?

Mr. **Morgan.** Well, I think what you suggested is not an unreasonable solution at all, Senator Nickles. If they want us to transport 400 million cubic feet per day, at least they ought to agree to give us take-or-pay credit for that 400 million cubic feet per day under some existing obligation we've got.

Senator **Nickles.** Because I think when we had the producer panel and that question was asked before to them, they were looking at, hey, they were going to have to basically eliminate all take-or-pay liabilities, maybe past maybe future, just for access. And I think you had a unanimous position against that. I appreciate your comment.

I'm going to ask a couple of quick-fire questions. One, all of you have mentioned—or all the producers have mentioned that there was negotiations and reductions in take-or-pay that have been happening. Has the FERC's rule hindered those renegotiations and negotiations on both access and on take-or-pay? Has it declined since the rule?

Mr. **Smith.** I think that we certainly expect that it will be more difficult to negotiate with the rule in effect. It's only been here for a few days or a few weeks; I can't say that there's been a change in the last couple of weeks.

Senator **Nickles.** I'm going to ask a whole bunch of quick questions——

Mr. **O'Neill.** Just very quickly, we've had one producer just recently, we had agreed on a settlement that had been going through their chain of command, and just shortly a couple of days ago all of a sudden, no. And I don't know why, but I will tell you it has not helped the process at all.

Senator **Nickles.** All of you have mentioned different reasons for not participating in the transportation rule. Most of you mentioned the 25 percent contract demand, although some of you said that wasn't the foremost problem. Is it a problem, though, or is it a hinderance as far as participating in the transportation rule for your pipeline?

Mr. **King.** Very definitely.

Senator **Nickles.** Is there anybody that finds that this isn't a problem?

Mr. **Morgan.** I'd just say this, Senator Nickles: it's a problem, but very secondary to the take-or-pay problem with our company.

Senator **Nickles.** And I hear a lot of you saying that if you're going to allow abrogation on one end, you want some abrogation on the take-or-pays.

Mr. **Terpstra.** We just talk about the 25 percent, but it's a fairly broad issue. We acquired a gas supply, as I said a little bit earlier, that was based on there not being transport. And even if the 25 percent is pulled back, we have to be sure that we aren't locked in the position where they pay demand charges and we still have to maintain the supply. So we do have to balance out the contractual right to take with the let's say, daily takes, what they do decide to take. So that nuance has to be recognized.

Senator NICKLES. FERC as you know is reconsidering the block billing proposal. As that proposal is presently being considered, do you favor it, or oppose it? Mr. King.

Mr. KING. We oppose the proposal, the block billing proposal.

Senator NICKLES. Mr. O'Neill.

Mr. O'NEILL. We're not particularly enthusiastic about that proposal at all. If it does go into effect, certainly what we've recommended is that you create the additional block so that you don't tie up gas that is market sensitive.

Senator NICKLES. But you don't favor it as it is right now?

Mr. O'NEILL. We're not particularly enthusiastic about it at all.

Senator NICKLES. You sound like a Senator. [Laughter.]

Mr. Morgan?

Mr. MORGAN. We're opposed to it, but if they do something, they need to put in a second block in block 2.

Senator NICKLES. Mr. Terpstra?

Mr. TERPSTRA. Our feeling is that if 436 is not altered, we're in favor of it with a block 2 (a) and (b) as a transitional mechanism. We have traditionally been a rolled-in price operation. We believe that's the way to go. But if 436 is not altered, we think it's the only possibility of giving us a transitional mechanism.

Senator NICKLES. So you oppose it unless the transportation rule stays as it is, and then you're in favor of it?

Mr. TERPSTRA. If 436 stays as it is, then we would like to have block 2 (a) and (b).

Senator. NICKLES. Then you want block billing. But you don't if the transportation rule is modified?

Mr. TERPSTRA. With correct modifications, we would not like block billing.

Senator NICKLES. Mr. Smith?

Mr. SMITH. We're opposed to block billing. If the Commission goes forward with it, we would strongly urge that there be a separate, segregated block for market sensitive gas, the so-called block 2 (a) and (b).

Senator NICKLES. Dr. Cooper?

Dr. MARK COOPER. We obviously support block billing. Having gotten the floor, let me make one observation on take-or-pay. I now understand how we got into this mess.

Senator NICKLES. Wait a minute. Before you make a speech, I've got a few questions.

Mr. Legato.

Mr. LEGATO. Mr. Chairman, we support the Commission's block billing proposal because we think it will, although in the short run it will reduce prices to producers for the highest cost gas, it will direct investment in the country into those gas fields where the marginal cost of production is at a price the consumers are willing to pay. In the long run——

Senator NICKLES. That's——

Mr. LEGATO [continuing]. It will increase efficiency.

Senator NICKLES. I'm just wanting some quick things.

I've introduced legislation—I think you're aware of it—on old gas. It would decontrol gas as those contracts expire, or as they're renegotiated, and it would eliminate the end-use restrictions. I haven't touched the transportation portions. That's the legislation as it is today.

Would you support that, Mr. King?

Mr. KING. We support it in the context of an overall resolution of the problems we are talking about today.

Senator NICKLES. OK. Mr. O'Neill.

Mr. O'NEILL. I think that would be our position, also, Senator. There may be some other problems that have to be addressed, we think.

Senator NICKLES. I hear you saying that you want to do more on take-or-pay. I haven't done anything on take-or-pay.

Mr. O'NEILL. That's correct.

Senator NICKLES. Mr. Morgan?

Mr. MORGAN. I would agree with what you said just then.

Mr. TERPSTRA. Our view is that renegotiation should not just be raising gas prices, because that adds to the pipelines problems. So our view is that, with the modification that both old and new contracts be subject to renegotiation, we would then find it acceptable.

Senator NICKLES. Let me make sure that you understand where I was coming from. I said, as contracts are mutually renegotiated. That's between you and your producers, whether it be old or whether it be new.

Mr. TERPSTRA. If it's read in that context, we could support it from the standpoint that we would then be able to prepare a package of old and perhaps new gas in a renegotiated package.

Senator NICKLES. Let me make sure that you also understand, we weren't saying that you would have to renegotiate every contract you've got. Those contracts would stay their term. You'd renegotiate them as they expire, unless you chose to renegotiate them before they would expire.

Mr. Smith.

Mr. SMITH. Yes. We would favor deregulation as a part of a comprehensive legislative approach, including the take-or-pay.

Senator NICKLES. Dr. Cooper?

Dr. MARK COOPER.As I said last summer, we oppose that legislation.

Senator NICKLES. Mr. Legato.

Mr. LEGATO. We would also, Mr. Chairman, because of the deregulation of old gas.

Senator NICKLES. Well, I'm just wondering. In your press conference that you're having in Oklahoma with some of our independent producers, if you're going to tell them that you're opposed to deregulation and that you're in favor of block billing?

Mr. LEGATO. Yes; they know that, and we agreed to disagree on that. But we also agreed——

Senator NICKLES. I was wondering if——

Mr. LEGATO. Yes, we do. We worked together on areas in which we have a mutual interest, both independent producers and consumers have a mutual interest in opening up the pipeline to get transportation service from the independent producers to the distribution companies.

Senator NICKLES. OK. I want to thank all of our panelists. I have some additional questions, but in fairness to our final panel, it's necessary to move on. I would appreciate—and for your information, I'm asking the FERC to provide us with relevant data to give us a more complete picture of what is taking place, the amount of gas that is moving on the spot market, and how much of that has been shut in for our information. Thank you very much for your participation.

If the next panel would please come forward.

To our final panel, one, I appreciate your patience and indulgence. As our first panelist we have Mr. Schroer, president and chairman of Northern Indiana Public Service Co., and he's also chairman of the American Gas Association.

Welcome.

STATEMENT OF EDMUND A. SCHROER, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, NORTHERN INDIANA PUBLIC SERVICE CO., AND CHAIRMAN OF THE BOARD, AMERICAN GAS ASSOCIATION, HAMMOND, IN

Mr. **Schroer**. Thank you, Senator, members of the subcommittee:

We appreciate the opportunity to appear this afternoon. In its notice of proposed rulemaking of May 30, the Commission brought forth a grand scheme described by them as a complete and total package, which many viewed as unnecessarily and rapidly restructuring the gas industry. Nevertheless, AGA responded to that proposal in a constructive way, and on the major issues our comments were largely ignored.

Frankly, that grand scheme has become a woefully inadequate and incomplete regulatory maize. On the most controversial issue, block pricing, the decision was postponed. The supplemental notice gives clear signals that the concensus of comments aimed at making block pricing workable, if indeed it were workable under any scenario, would be by dividing block 2 into two parts, and that was going to be ignored, likely. With two new Commissioners available to consider the issue, it's equally likely that there will be a period of prolonged uncertainty.

On take-or-pay, which the Commission and virtually everyone else acknowledged to be a major problem, the Commission responded to the widespread criticism of their proposed solution in NOPR by docketing it all together in Order 436. So we have pieces of the grand design that are out of balance. Yet, pipelines are criticized from all sides because they are not blindly and automatically stepping up to a one-sided regulatory program.

As AGA emphasized in our request for rehearing at the Commission that we filed last week, and in our House testimony last week, that FERC should give pipelines some incentive to step up and voluntarily accept the open access transportation option. That incentive should focus on alleviating their take-or-pay problems, not aggrevating them. In our opinion, that incentive should be a very logical and uncomplicated step.

When any producer avails itself of the open access benefits offered by a pipeline, the producer must, as to that pipeline alone, in the nonmarket responsive contracts, those without market-out or price redetermination provisions, waive the take-or-pay obligation. So the producer would have two alternatives: Either make that waiver, or renegotiate the high-price nonmarket responsive provisions in its contracts.

Senator Nickles, I've read your resolution, Senate Resolution 255, and commend you for the four numbered proposals therein. But I urge you to amend it by being more specific in what the Commission should do.

As to point 1 of the resolution, we suggest that you urge the Commission to remove the disincentives for natural gas pipelines to provide voluntary transporation of natural gas for others. We're urging you to consider making that more specific by including the condition I just mentioned, that any producer who avails itself of open access, either waive take-or-pay obligations or renegotiate the higher priced nonmarket responsive provisions.

As to your point 3, we would suggest to you that we urge the Commission to take such action as possible pursuant to the Natural Gas Act and the Natural Gas Policy Act to be more specific, and ask the Commission to remove all conditions on section 311 transactions. Section 311 transactions have been very effective over the past 7 years in moving gas from points of oversupply to where it's needed.

We'd also submit that if the Commission deals with the take-or-pay problem effectively and defines pricing problems, no matter whether they're right, wrong, or indifferent, at least the parties know what the policy is rather than trying to deal in long-term/short-term contractual arrangements without knowing what the pricing policy is going to be that's relevant to those decisions. We suggest to you, Senator, and committee members, that if those two things were done, the pipelines would voluntarily submit—voluntarily participate, if you will, in the open access transportation program.

I would like to conclude my comments as an AGA chairman by briefly discussing a major concern of the association. That is, pipeline and distributor bypass under Order 436.

We are not saying that there should not ever be a bypass. We are saying that there should not be bypass without a specific finding that the public convenience and necessity will be served by the bypass. The Commission must ensure that its certificated procedures should not replace either legitimate State authority or statutorily delegated Federal responsibility. The Supreme Court of the United States has spoken decisively on those issues.

Departing from the presentation, Senator and committee members, as an AGA official, I would like in light of the discussion this morning to make just a couple of comments as a distributor.

I don't have the perception, nor has our company, because it has not been the fact, that pipelines have overreached and rendered us a disservice. We've had excellent relations with all five of our pipelines since I started with the company in 1957. And I think the kind of fingerpointing within this industry that comes by sector, who's doing the gouging sort of mentality, is very unfortunate and does not serve the customer, does not serve the public. I think the political structure tends to mislead the public, unwittingly, out of that dialog. I think the regulatory structure does. I think all the segments of the industry tend to mislead the public, because the public is and has been well served by the gas industry.

In our territory alone, $100 worth of gas this afternoon is $150 worth of oil. Now our customers aren't disadvantaged. They haven't been disadvantaged. I think the public good would be much better served if this industry were able to do as you indicated earlier this morning, reach a consensus and come to you with it, than sending out what I believe is a misleading message that the public is not well served by this industry, and the question is who is doing the disservice.

Thank you.

[The prepared statement of Mr. Schroer follows:]

TESTIMONY OF
EDMUND A. SCHROER
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORTHERN INDIANA PUBLIC SERVICE COMPANY AND CHAIRMAN OF THE BOARD AMERICAN GAS ASSOCIATION
BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
ON THE FINAL RULE IN FERC DOCKET NO. RM85-1-000 REGULATING NATURAL GAS PIPELINES AFTER PARTIAL WELLHEAD DECONTROL, ORDER NO. 436

November 21, 1985

INTRODUCTION

Mr. Chairman and members of the Subcommittee:

My name is Edmund A. Schroer, and I am Chairman, President and Chief Executive Officer of Northern Indiana Public Service Company.

Today, however, I am testifying in my capacity as Chairman of the American Gas Association (A.G.A.)

On behalf of A.G.A.'s member companies, I thank the Subcommittee for allowing us to present our views on the Federal Energy Regulatory Commission's final rule on the Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol, Docket No. RM85-1-000, issued on October 9, 1985.

The American Gas Association (A.G.A.) is a national trade association whose members consist of nearly 300 natural gas distribution and transmission companies serving more than 160 million consumers in all 50 states. Collectively, our member companies account for 85 percent of all gas utility sales.

A.G.A. and its member companies have participated actively in every stage of the proceedings in Docket No. RM85-1, from the first Notice of Inquiry issued on December 24, 1984, to the present. This included all hearings and all written comment opportunities that were part of the Commission's NOI and NOPR proceedings. The culmination of almost a year of activity has been FERC's issuance of Order No. 436 on October 9.

A.G.A. is aware that the Commission has adopted a number of the recommendations we have offered during the course of the Docket No. RM85-1 proceedings. Nevertheless, A.G.A believes that much of what remains in Order No. 436 is harmful to the natural gas industry, and to the consumer we endeavor to serve. A.G.A. sees many deficiencies in the Final Rule that are serious enough to impair both the equity and effectiveness of the entire Order.

The gravest deficiencies in the Order are as follows:

1. The Order fails to provide meaningful take-or-pay relief for interstate pipelines. At the same time, it increases the risks facing pipelines and actually boosts the bargaining power of producers by permitting them to seek unilateral expedited abandonment. Without action to strengthen this weak link in the Order, none of the Order's other major policies will work with much equity or effectiveness: competition between interstate pipelines will be distorted by differences in take-or-pay liability, and competition between interstate pipeline gas supplies and

"spot market" gas supplies will be nearly impossible. In addition, interstate pipelines will be rendered unduly sensitive to any courses of action -- including the acquisition of blanket transportation certificates -- which pose the risk of otherwise avoidable load loss.

2. The Order abruptly terminates certain existing carriage programs, regardless of whether the various parties are willing to make them non-discriminatory. This termination policy -- which was, in some cases, adopted without providing opportunity for public comment -- is already disrupting vital gas transportation services. The policy is also pressuring interstate pipelines to make irrevocable elections, with irrevocable consequences, before they know whether the Commission will adopt block pricing or retain full rolled-in pricing.

Because of these, and other serious problems with the Order, A.G.A. found it necessary to file petitions asking for a partial stay of the Order with the Commission, and we filed a motion for partial stay of the Order with the D.C. Circuit Court, which motion was denied. In addition, A.G.A. filed with the Commission for rehearing of the rule on November 8, 1985.

I will begin by examining the problems that A.G.A. found upon analysis of Order No. 436.

PROBLEMS WITH ORDER NO.436

A. The Commission failed to provide an equitable remedy for the take-or-pay problem.

Much ado has been made in recent years on the effect of take-or-pay clauses in a pipeline's contract with its producers. It is a foregone conclusion that, because a take-or-pay clause forces a pipeline to purchase expensive gas from a producer or pay for it anyway, the true burner-tip price of gas never gets back to the producer, and it forces prices to the consumer to a higher level than would otherwise be the case. These kinds of market distortion caused by take-or-pay clauses are probably the single most important reason for the problems our industry faces today. A.G.A. was pleased that the Commission eliminated the "safe harbor" proposal in the NOPR.

However, rather than deal with the take-or-pay problem head-on, the Commission merely reaffirmed the approach taken in the policy statement on take-or-pay buyouts, Docket No. PL85-1-000. FERC should have done more. In responding to the Commission's NOPR in Docket No. RM85-1, A.G.A. informed the Commission that there are three actions that it could legally take, above and beyond what the Commission proposed, to help the pipeline deal with the take-or-pay problem. These actions are:

1) The Commission should condition a producer's access to the pipelines' transmission system on producer waiver of take-or-pay claims.

2) The Commission should hold that take-or-pay payments, for gas that cannot be made up, are void to

> the extent that they violate NGPA Title I ceiling prices.
>
> 3) If the Commission allows producers to seek unilateral abandonment under its new Section 2.77 of the regulations, it should require producers to waive both accrued and future take-or-pay liability under the contract, and to refund take-or-pay pre-payments that already have been made for gas volumes that can no longer be made up.

A.G.A. is extremely disappointed that the Commission did not act on any of these proposals. I will now discuss in greater detail the Commission's response to A.G.A.'s suggestions, and how important it is to the industry that the Commission implement them as soon as possible.

As to producer waiver of take-or-pay claims for access to pipeline transportation under Part 284, the Commission expressly declined to link transportation for producers to contract renegotiation. In the text accompanying the final rule, the Commission gave two reasons why it cannot link transportation to take-or-pay relief:

> 1) the Commission contends that it does not have the authority to regulate producer contracts, and
>
> 2) such a condition would discriminate against producers, and thus would be contrary to the U.S. Court of Appeals decision in Maryland Peoples Counsel v. FERC.

In response to the first argument, A.G.A. strongly believes that the Commission has the authority to add such a condition to pipeline transportation of producer gas.[1] By instituting this condition, the Commission is not regulating either first sales or producer contracts. Rather, the Commission would be fulfilling its own statutory mandate to regulate the transportation of natural gas. In fact, the condition A.G.A. seeks is similar to condition (H) in the now expired Special Marketing Programs, and to Condition (c) in the Commission's recent orders granting limited-term abandonments.

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[1] Panhandle Eastern Pipeline Co. v. Public Service Commission 360 U.S. 507 (1947).

In response to the Commission's second argument against the proposed condition, although the condition only applies to producers, it is not unduly discriminatory. I am emphasizing the word undue, because that is the standard set forth by the Natural Gas Act. The Commission already incorporates this standard in the Final Rule.

The Commission has broad authority to condition certificates under Section 7 of the Natural Gas Act. The Supreme Court has held that the Commission has the express power to attach to a certificate "such reasonable terms and conditions as the public convenience and necessity may require".[2] Thus, if the Commission finds that the condition meets this test, it has complied with the Natural Gas Act. Considering the enormous take-or-pay liability that eventually will be borne by the public absent such a condition, this condition on pipeline transportation access is required by the public convenience and necessity.

As to take-or-pay payments that violate Title I of the NGPA, A.G.A. believes that the Commission must be required to enforce the NGPA. In our opinion, Title I would be violated if the total price per unit of gas taken exceeds the NGPA ceiling price when take-or-pay payments for gas volumes which cannot be made-up are added to the price of gas that is taken. Therefore, A.G.A. contends that the Commission should enforce the NGPA by voiding take-or-pay payments to the extent that they violate the NGPA price.

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[2] Atlantic Refining Co. v. Public Service Commission, 360 U.S. 378 (1959).

Finally, as to waiver of take-or-pay payments to allow unilateral producer abandonment, A.G.A. believes it is imperative that the Commission require producers to waive both past and future take-or-pay payments under the contract to be abandoned, as well as refund take-or-pay payments that have already been made for gas volumes that can no longer be made up. This is because abandonment does not necessarily void the obligation in the underlying contract. Therefore, producers could attempt to hold the pipelines liable for 100 percent of the accrued take-or-pay liability at best, and perhaps for prospective liability under the contract at worst. If the Commission allows producer abandonment without take-or-pay forgiveness, it effectively allows the producer to sell the gas twice. The original buyer has absolutely no leverage under the Commission's plan to renegotiate the contract. Because of this, A.G.A. believes that take-or-pay forgiveness must be a part of any unilateral abandonment scheme.

In conclusion, A.G.A. has been working with the Commission to help it "see the light" in the take-or-pay area. If the Commission would heed our advice on the above-mentioned proposals, it would begin to reduce the role take-or-pay provisions play in distorting the natural gas market. The process of moving gas toward a more competitive market could be facilitated considerably by these actions.

I must emphasize that Congress also has the ability to help pipelines rid themselves of the take-or-pay problem. The best way to eliminate the take-or-pay problem is to increase gas demand. Repeal of the Fuel Use Act and incremental pricing provisions of the Natural Gas Policy Act of 1978 would free the natural gas industry to compete fairly with other forms of energy. As natural gas regains its proper share of the energy market, and natural gas use increases, the take-or-pay problem will be a thing of the past.

B. Improper rule changes.

By abruptly terminating certain existing carriage programs, the Commission has gone far beyond the actions required by the *Maryland People's Counsel* decision. In one case, the Commission has acted in a manner that disregards the procedural requirements of the Section 551, *et seq.* of the Administrative Procedure Act (APA).

On October 24, 1985, the Commission issued an errata to the Final Rule, which contained a series of "technical corrections" to Order No. 436. The "corrections" that the Commission made included changes to the date by which transportation arrangements must have commenced in order to allow these arrangements to be grandfathered past the applicable date for termination in Order No. 436. The Commission changed the date by which transactions must be commenced to be grandfathered from November 1, 1985 under the Final Rule to October 9, 1985. This is a significant change, and has adversely affected many distributors and end-users who relied on the date given in the original Order. In fact, one company has spent approximately $215,000 for facilities to receive gas in reliance on the original date, only to find out that the transportation agreement in question will not now qualify for grandfathered status under the rule.

A.G.A. believes that these "technical corrections" are actually substantive policy changes that will have a materially negative impact on the natural gas industry. As we have seen, many gas companies and gas consumers have expended tremendous amounts of time, energy and money in reliance on the language of the original Final Rule. Consequently, the change in Commission policy governing the ability to grandfather certain transactions--a change that was made without the public comment opportunities required by the Administrative Procedure Act--is at best unfair to those who relied on the original language of Order No. 436. At worst, the policy change is a blatant disregard of the procedures required by the A.P.A.

These procedural problems have led to disruption of carriage to the natural gas distributor and end-user. Those most affected by the change of the rules in the middle of the game--the natural gas consumers--have now lost valuable time in their battle to continue their transportation arrangements on a non-discriminatory basis. A.G.A. has urged the Commission to re-examine its position on NGPA Section 311 transactions and other existing carriage programs. A.G.A. has also asked the Commission to return to the original effective date found in the text of Order No. 436.

C. The Final Rule is incomplete.

A.G.A. believes that Order No. 436 is deficient because interstate pipelines and local distribution companies must make crucial decisions, with irrevocable consequences, before these companies know whether the Commission will implement some form of block pricing scheme or retain rolled-in pricing. This concern is so great that A.G.A. filed with the Commission a petition for a partial stay of Order No. 436. The stay would have applied only until 30 days after FERC's final decision on block pricing -- and would not have affected those provisions necessary for continuing carriage programs on a non-discriminatory basis. The Commission rejected our petition, and we subsequently filed a similar motion with the D.C. Circuit Court. The court decided against instituting a partial stay as well.

In our subsequent Request for Rehearing at the Commission, we again urged the Commission to delay the deadlines for irrevocable elections until 30 days after the

Commission's final decision to accept or reject block pricing. I must emphasize at this point that the stakes involved in this situation are truly monumental.

First, the interstate pipelines face a terrible plight by being forced to decide whether or not to engage in blanket transportation without knowing whether block pricing or rolled-in pricing will prevail.

A pipeline must weigh the risks of opting for nondiscriminatory transportation against the risks of choosing to remain in a merchant role. This decision is in itself a difficult one for the pipeline. However, the difficulty in determining which option to pursue increases exponentially when a pipeline does not know whether block pricing or rolled-in pricing will prevail.

In short, pipelines cannot weigh the risks of one decision against the risks of another decision when the risks will change dramatically under different outcomes of the block pricing deliberations. Yet, because a pipeline must choose shortly or assume by default (at least temporarily) the risks of remaining a merchant pipeline, the pipeline must make a blind choice with consequences that cannot be undone.

I must also emphasize the irrevocability of this uninformed decision a pipeline will have to make. If a pipeline decides against providing nondiscriminatory transportation, it almost immediately loses much of its existing carriage load. It may be impossible to regain this load if these customers have shifted to alternate energy sources or competing pipeline suppliers. Furthermore, the pipeline that opts for open access carriage also has to allow its firm sales customers to reduce, or convert to carriage, their current sales contract demand. Once shed, this contract demand may never be regained by the pipeline.

In conclusion, both distributors and pipelines alike will be forced by Order No. 436 to make crucial decisions without all of the information available, where risks and benefits cannot be properly weighed and acted upon. The natural gas consumer would unfortunately be the big loser if miscalculations are made by pipelines and distributors because all of the facts are not known.

For the above reasons, A.G.A. believes that the Commission should delay implementation of the whole final rule until the block pricing controversey is resolved, while continuing all transportation programs allowed under current law, on a nondiscriminatory basis.

D. The Final Rule on expedited certificates is deficient in several areas.

In A.G.A.'s comments on the NOPR, we supported the overall concept of optional, expedited certificates that the Commission proposed. Nevertheless, A.G.A. believes that a number of problems still remain in the expedited certificate portion of the Final Rule.

Bypass continues to be our primary concern. Bypass inherently poses such weighty matters of public interest that the procedures for considering bypass approval should be cautious, deliberate, cognizant of applicable State prerogatives, and designed to assure full consideration of the views and interests of all affected parties.

Attached to the testimony is a critique done by A.G.A. on the McKinsey and Company report on distributor by-pass. Our critique shows that, even though the McKinsey report correctly concludes that residential gas consumers will pay more for gas as a result of bypass, it incorrectly assumes that these higher system charges will be offset by lower gas costs. A.G.A. believes that both system costs and gas costs will go up as a result of distributor by-pass.

In A.G.A.'s written comments on the NOPR, A.G.A. recommended that, when a pipeline bypass of another pipeline or a distributor is the issue, the applicant should have the burden of proof, not the intervenor. There should be no presumption that an expedited certificate is in the public convenience and necessity when it would be used to bypass either a pipeline or distributor. In the Final Rule, however, the Commission decided to retain the rebuttable presumption in favor of the applicant. A.G.A. strongly believes that retaining the rebuttable presumption in favor of the applicant in cases of bypass is a major mistake, for the following reason: Bypass either at the pipeline level or distributor level could shift fixed costs unfairly onto remaining customers. Even though opinions differ on whether or not this factor alone automatically justifies denial of a bypass, it is widely agreed that this concern requires a careful Commission examination of the facts of each case.

The retention of a rebuttable presumption which favors the applicant, combined with the abbreviated time frame for Commission decision-making in an optional, expedited certificate, creates an atmosphere where the Commission is prejudging issues that are charged with major public interest implications. The belief that the public convenience and necessity can be determined by market forces alone does not make sense when it comes to the issue of bypass.

For the above reason, the rebuttable presumption in favor of the applicant should not be available when bypass is in issue.

E. The block pricing proposal

I would like to give your our basic views on the new block pricing proposal. In our comments on the NOPR, we supported rolled-in pricing; but we also said that, if the Commission decided to go forward with block pricing, then it should subdivide block 2, creating a new block 2a for gas sold under new or market responsive contracts, and a block 2b for all other gas.

Market responsive contracts are defined by A.G.A. as those contracts that: (1) have a market out or price redetermination clause; or (2) are entered into or renegotiated after the effective date of this rule. This would remove any non-market sensitive gas (whose purchase may be mandated under multi-vintage contracts or state prorating regulations) from the significant quantity of market-sensitive gas in block 2. This subdivision would have the effect of substantially reducing take-or-pay exposure that would otherwise result from block pricing as proposed by the Commission.

Over 12% of all block 2 gas is sold under multivintage contracts. This means that if a pipeline buys block 1 gas under these contracts, the contract may require it to purchase some block 2 gas. Some state prorationing laws, which require ratable takes from a common pool or reservoir, have the same effect. Thus, certain block 1 purchases may necessarily entail some block 2 purchases. A pipeline can minimize or maximize its block 1 purchases, subject to minimum take-or-pay requirements. However, as just discussed, maximum block 1 purchases will also increase takes of non-responsive block 2 gas (see above discusion of prorationing and multi-vintage contracts). This non-market responsive block 2 gas will increase the average block 2 price, potentially making the rolled-in price of all block 2 gas non-competitive.

This situtation could be redressed by subdividing Block 2 into a market-responsive block 2a and a non-market responsive block 2b. Then, the high priced gas that the pipeline has to take, because of multi-vintage contracts or state prorationing, would not automatically poison the competitive position of market sensitive block 2 gas.

In its Request for Supplemental Comments, the Commission considered subdividing block 2 but declined to so do because "nothing in the revised proposed rule (or indeed in the existing regulations) would require a pipeline to purchase gas supplies that cannot be resold." (50 F.R. at 42385). The Commission has not analyzed the effect of contracts or regulations that link some low cost gas purchases (either block 1 or market responsive block 2) to non-market responsive gas. This failure colors the Commission's proposed rule, the questions it asks, and its theoretical rationale in Exhibit S.

In the text accompanying the proposed rule, the Commission asks six specific questions. Our answers to these questions make up the body of our comments to FERC, and clearly set our our rationale for blocks 2a and 2b. The Commission also asked for comments on its economic model for predicting gas price, supply and demand, which is set out in Exhibit S of the notice. A.G.A.'s analysis of Exhibit S shows that the model omits some key features of the natural gas market and understates the block 2 price because it does not consider the effect of rolling-in non-market responsive gas into block 2. Lastly, the Commission notes that it decided to request supplemental comments because various producers and end-users testified that block pricing would have disastrous effects on gas supply. We do not entirely agree. While block pricing will have an effect on gas supply and price, we believe these effects have not been fully analyzed and therefore are overstated. We have attached our own analysis to our comments on the proposed rule, which rebuts some of the adverse supply studies that have been submitted to the Commission.

CONCLUSION

For the above reasons, A.G.A. believes that the Commission should delay implementation of the whole final rule until the block pricing controversy is resolved, while continuing all transportation programs allowed under current law, on a nondiscriminatory basis.

A.G.A. has supported the Commission's efforts as it tries to help the natural gas industry redirect its mode of doing business into a deregulated mode. However, the problems I have discussed with you today will make the Final Rule unfair and very difficult to implement. We are working with the Commission to help rectify these problems.

Only when the this is done will the Final Rule become a workable tool for the industry to use to help its transition into the deregulated market.

Thank you for allowing me to speak before you today. At this time, I will answer any questions you may have.

American Gas Association

November 8, 1985

CRITIQUE OF MCKINSEY & COMPANY REPORT ON DISTRIBUTOR BY-PASS

A report prepared for Bethlehem Steel Corporation by McKinsey and Company attempts to prove that distributor by-pass by large industrial firms need not hurt residential and small commercial customers. While the Report acknowledges that by-pass will increase gas distributor non-gas costs (which will be eventually passed on to residential consumers), it assumes most of these costs will be "made-up" by lower distribution company gas acquisition costs. In fact, by-pass will result in higher gas costs to distributors.

Th Report's conclusion that gas acquisition costs to distributors will decline as a result of by-pass is supported by two assumptions: (1) the threat of by-pass will induce distributors to be "more competitive" in their gas acquisition strategy and, (2) by-pass, by reducing distribution company load, allows distributors to reduce takes of their most expensive gas supplies. Both of these assumptions are incorrect. The analysis performed in the McKinsey Report neglects: (1) seasonal and peak gas purchasing patterns; (2) distributor contractual limitations in gas purchasing practices; and (3) the longer-term negative supply implications to distributors' ability to purchase low cost gas that result from the loss of large industrial customers.

The McKinsey Report is very straightforward in its methodology. The Report examines the gas purchases of a number of gas distributors for 1983, segregating major gas supplies from pipelines on the basis of price. The Report then assumes that any reduction in a distributor's gas sales as a result of an existing industrial customer by-passing the distributor reduces the highest cost purchases of that distributor -- thereby reducing the distributor's weighted average gas purchase price. This methodology is incorrect -- and in many cases the diametrically opposite result is true. First, because of contractual commitments and physical, gas transportation limitations, a distributor's lowest cost gas is often the last to be purchased and necessarily the first to be shed. This is especially true today, with the spot price of gas in the field hovering in a price range just above $2.00/MMBtu and the average interstate pipeline weighted average cost of gas (WACOG) at about $2.60/MMBtu. Distributors often purchase pipeline system gas first because of contract penalties (e.g. minimum bills and demand charges) that would be incurred if this gas wasn't taken. Then distributors purchase lower cost incremental supplies to satisfy the rest of their customers' requirements. The loss of an industrial customer would necessarily force a distributor to back off lower priced gas supplies, forcing up its WACOG.

A second incorrect assumption in the McKinsey Report is that all distributors have the physical capability of displacing all their supplies. For many distribution companies, certain parts of their systems are served by different interstate pipelines. In these cases, a higher cost pipeline that serves another, disconnected geographical area cannot be displaced. Some of the "economic benefit" of by-pass quantified in the McKinsey Report resulted from a failure to recognize this fact.

A third error in the McKinsey Report is the failure of the analysis to recognize load factor characteristics of different gas customers. A large industrial customer that has the capability to by-pass a distributor will almost always be a high load factor customer. The loss of such customers would hurt a gas distributors ability to acquire new, low cost gas supplies. This is especially true as FERC attempts to unbundle interstate pipelines gas services and rates. This unbundling process should eventually increase the cost of heating season and peak gas supplies and place a premium on distributors maintaining relative high load factors. In addition, the loss of high load factor industrial customers as a result of by-pass will impede a distributor's ability to buy low cost gas directly from producers.

Finally, it is argued that the threat of by-pass will force distributors to be more competitive in their gas purchasing practices. History on recent gas purchasing practices indicate that gas distributors have been very aggressive in bringing their gas prices down -- being the most frequent users of new FERC transportation programs to acquire low cost gas in the field. In addition, gas distribution companies have "opened-up" their systems to carriage of user owned gas -- where the user feels it can acquire lower cost gas in the field. By-pass is therefore not a means of disciplining distributor gas purchasing practices; but rather a means of avoiding state regulated gas rates (which sometimes cross-subsidize lower residential rates with higher industrial charges).

In summary, the McKinsey Report correctly concludes that residential gas consumers will pay higher distribution system fixed charges as a result of by-pass. It incorrectly assumes that these higher system charges will be offset by lower gas costs. In fact, it is likely that both system charges and gas costs will go up as a result of distributor by-pass.

Senator NICKLES. Mr. Schroer, thank you very much.

Our next panelist is Mr. William C. Cooper, chairman of the United Distribution Co., from Pennsylvania.

STATEMENT OF C. WILLIAM COOPER, CHAIRMAN, UNITED DISTRIBUTION COS., SEWICKLEY, PA

Mr. WILLIAM COOPER. United Distribution Cos. is a group of 31 distribution utilities serving in 10 States. It represents about 20 percent of the distribution business throughout the United States.

I appreciate the opportunity to appear. This has been a very interesting session, to hear the producers and the pipelines and certain consumer advocates today. I would like to bring to your attention another phase of this rule which hasn't surfaced in great detail yet, although Mr. Schroer mentioned it in one aspect in his statement for AGA.

That is, that this rule has many aspects of it which are very detrimental to distribution utilities. The pipelines say they have been disadvantaged. There are certain major things wrong with this rule from a distribution standpoint. I would like to briefly mention those. Now before coming to those, let me say that our group of utilities is in favor of transportation, and we have been benefiting greatly by transportation under the old regulations.

We have been—we are in favor of open access transportation. We support that aspect of this rule. We have, up to date, I might say, while Senator Bradley isn't here, we have opposed his mandatory bill to date because it always disadvantaged distribution companies from the standpoint of capacity.

Now the rule, coming to what is wrong with it from a distribution standpoint, there are four aspects that I mention in our statement. But we have attached to our statement our application for rehearing to the Commission which enumerates them in detail.

Now the four that I wanted to bring to your attention specifically are: The bypass question, which Mr. Schroer has mentioned, for which the Commission has set up very bad processes. We think the process will have to be in accordance with the Natural Gas Act.

The capacity problem is a big problem in this rule because the rule would undermine the capacity that's now used for utility service.

The rule sets up rate standards which would give transportation a preferential free ride at the expense of utility service.

The rule sets up new abandonment processes which were not heard during the hearing, which allow the abandonment of reserves without any opportunity—real opportunity for distribution companies to get in there and try to see whether that's in the public interest.

Now those things, we say, and certain others, must be corrected. I also agree with what Mr. King said this morning on behalf of the pipelines. That is, that this rule completely undermines the merchant function of the pipelines, and that is something we have depended on to the public good.

Now our view is that the rule ought to be stayed, and we asked the Commission to do that but they denied our motion yesterday, until—stayed until it is completely reconsidered, and that in the meantime the Commission should reinstitute the old transportation regulations, and keep transportation going. It was growing, and it can continue to grow under those regulations, and they can be patched up to meet the open access mandate of the court of appeals.

Therefore, that's what we think ought to be done. There are pipeline problems under this rule. There are distributor problems. There are producer problems. This whole thing ought to be reheard and, in the meantime, keep us going on the old things which were doing a lot of good and which we've now had interrupted.

Incidentally, the Commission in its order says that its old regulations were doing a good job in the public interest.

Senator Nickles, we compliment you on your proposed resolution. We would respectfully suggest, and we would hope you might direct your testimony to the Commission to this effect, that the resolution and your testimony, if I may be so bold, should say to this Commission, put this whole thing on the shelf for awhile and reconsider it, and let's get back on the track with the old regulations.

Thank you very much.

[The prepared statement of Mr. William Cooper follows:]

STATEMENT OF C. WILLIAM COOPER, CHAIRMAN
UNITED DISTRIBUTION COMPANIES
(Filed November 19, 1985)

BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION
OF THE
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

Oversight Hearing on FERC Order No. 436
November 21, 1985

Chairman Nickles and Members of the Committee:

I am Chairman of United Distribution Companies, -- "UDC" -- a group of 31 gas utilities operating in 10 states in the Midwest and Northeast and rendering more than 20 percent of utility service throughout the United States. A description of UDC's Members, purposes and activities is attached as Appendix A. We thank you for the opportunity to participate.

My statement will be directed to four matters of immediate public concern

(1) those major errors which Order 436 commits upon utility service to the public, and the irreparable public harms which will result;

(2) the current emergency caused by Order 436;

(3) those steps which the Commission must now take in the public interest, - i.e.: (a) stay the Order while all issues are reconsidered -- the order being an integrated whole; and -- (b) meanwhile, move transportation ahead by emergency reactivation of prior regulations in modified form; and

(4) the Senate Resolutions sponsored by Chairman Nickles and by Senator Metzenbaum. UDC supports action of this kind but, respectfully, suggests that the Resolution be directed toward point (3) above.

1. Order 436 Commits Major Errors and Will Cause Irreparable Harm to Utility Service to the Public.

Let me say at the start that UDC Members support transportation as a useful adjunct to normal supply operations, which are based primarily on purchases of assured long-term supplies from pipelines. UDC supports transportation without undue discrimination under and pursuant to the Natural Gas Act and Natural Gas Policy Act. UDC, therefore, supports those basic provisions of Order 436 which are directed to these ends.

From the start of this proceeding, however, UDC has questioned numerous other terms and conditions of Order 436; and on November 8th, we filed an application for rehearing challenging these points. A copy of this Application is attached.

We also moved that Order 436 be stayed pending essential hearings and reconsideration, which motion is still pending as of this date (November 19th).

As UDC's application for rehearing shows, Order 436 adopts standards and administrative processes which are clearly illegal under the Natural Gas Act, -- which will depreciate pipeline service to utilities for the benefit of the public, and -- which will irreparably harm those consumers whom the Natural Gas Act protects. Most notable among these errors are the following:

(1) Through loose and unlawful processes which encourage direct sales to numerous large end-users, Order 436 will authorize unsound bypasses of utility service

which will irreparably harm residential, commercial and small industrial users. Correct statutory processes must be restored. These direct sale arrangements must be considered in proper fashion; and the fundamental public interest standard of the Natural Gas Act must be observed.

(2) Through loose and unlawful administrative processes which allow pipeline capacity to be oversold, Order 436 will depreciate existing service to utilities for the benefit of the public. Either sound hearing processes must occur before new services are authorized, -- as specifically required by the Natural Gas Act, -- or the Order must expressly condition new services on full protection of existing services.

(3) In defiance of established ratemaking processes, the Order mandates unlawful rate standards which offer a preferential "free ride" to new transportations for end-users, thereby: (a) thrusting an improper share of pipeline costs onto utility service to the public; and (b) opening the way to unfair competition against utility service to all consumers.

(4) With neither prior notice nor public hearing, Order 436 establishes unfair and unlawful processes, which encourage, and will permit, release of gas reserves now dedicated to public service -- to the greater

cost and detriment of future pipeline services to utilities for the public good.

Order 436 clearly violates those protective processes which have been mandated by Congress. In the public interest, and particularly the interest of all consumers protected by the Natural Gas Act, the Order must be reheard, extensively reconsidered and materially revised.

2. Order 436 Has Caused an Emergency in Transportation.

Pursuant to transportation regulations and orders which were in effect for months prior to November 1st, UDC Members made increasing uses of transportation to bring gas into their own general system supplies or to specific end users. These arrangements: (1) reduced the costs of supply for public service; (2) provided new operating flexibilities; (3) prevented users from switching to other fuels; and, (4) provided a competitive prod toward improved pipeline rates.

Through unwillingness of many pipelines to accept the 45-day transition provision, Order 436 has already caused many of these arrangements to be interrupted; and, judging from positions recently stated in public hearings, there now exists the probability of even more serious and permanent interruptions following expiration of that period.

3. The Commission Must Stay Its Order and Get Transportation Restarted Through Emergency Reactivation of Its Former Regulations and Orders in Modified Form.

In issuing Order 436, the Commission chose a dangerous and revolutionary course:

(1) which is loaded with novel processes and standards of doubtful legality, which will embroil the industry in litigation for years;

(2) which bids fair to disrupt the whole industry and compound market disorders; and

(3) which will cause immediate and irreparable harm to utility service to the whole public, -- whose protection Congress has mandated.

The Commission is an agency charged with the duty of administering specific Congressional mandates in the public interest. It ought not, and cannot, play with economic and regulatory fire. It cannot, in good conscience, blindly charge forward causing irreparable harm simply to see what happens and how things ultimately are sorted out by the Courts.

At the start of this proceeding, UDC urged the Commission to advance transportation and new business methods through modification and adaptation of ongoing regulations and in clear compliance with the mandates of Congress. Transportation was increasing and being broadened by leaps and bounds through that process. And that process can continue to grow. So in the emergency which now seems evident, UDC has again urged the

Commission to stay its Order to permit reconsideration. For the interim period, the Commission should promptly reactivate its prior regulations and orders, in modified form. It can readily tailor those regulations and orders to the mandates of the Court of Appeals in the Maryland Peoples Counsel Case. It can speedily make other modifications on an emergency basis.

This course will allow the industry to move forward while Order 436 is sorted out and placed in sound condition. Under the circumstances, this must be the course which serves the public interest.

4. The Senate Resolutions Sponsored by Chairman Nickles and by Senator Metzenbaum. UDC Supports Action of This Kind, But Respectfully, Suggests That the Resolution Be Directed Toward Point 3, Above.

Some people are saying that Order 436 precipitates the need for legislation. But, considering the divisive industry and Congressional debates of the last session of Congress, the errors of Order 436 cannot be responded to through that route. Rome will burn, meanwhile.

Therefore, UDC compliments Chairman Nickles and Senator Metzenbaum in proposing Senate Resolutions directed toward Commission action. Yet, as to each, we respectfully urge modification.

The Resolution proposed by Chairman Nickles asks the Commission to immediately revise Order 436 in such fashion as will cause pipelines to accept new certificates and transport pursuant to its revised terms. The trouble is that pipelines may well require modifications which will immediately harm public service while, at the same time, demanding retention of those unlawful standards and processes, -- enumerated above, -- which will cause irreparable harm to utility service. The Commission heard and considered its Order as an integrated whole. It should not be modified through an emergency process which takes into account only the desires and demands of the pipelines. That is why the stay and reactivation process set forth in Point 3 appears to serve the whole public interest.

The resolution proposed by Senator Metzenbaum, on the other hand, does not go far enough. We respectfully suggest that the general admonition be directed to Point 3 above.

* * * * * * * * *

Thank you again; and I will be glad to respond to your questions.

Respectfully submitted,

C. William Cooper
Chairman
United Distribution Companies
603 Broad Street
Sewickley, Pennsylvania 15143
(412) 741-4836

DESCRIPTION OF
UNITED DISTRIBUTION COMPANIES

UDC is an ad hoc group of organizations which provide gas utility service to the general public. The UDC Group was formed in 1976 and presently comprises 31 organizations rendering in the aggregate more than 20 percent of all gas utility service throughout the United States. The names and general locations of the members of UDC are set forth on the following page.

The members render service in the states of:

ILLINOIS
INDIANA
MICHIGAN
MISSOURI
NEW JERSEY
NEW YORK
OHIO
PENNSYLVANIA
WEST VIRGINIA
WISCONSIN

Among the metropolitan areas served are:

Akron
Albany
Buffalo
Chicago
Cleveland
Dayton
Indianapolis
Jackson
Jefferson City
Milwaukee
Pittsburgh
Peoria
Rochester
Syracuse

The UDC Group was formed and continues to operate for the purpose of protecting the interest of public utility service in sound natural gas supplies. To this end it has, over the years, participated in numerous rate and other regulatory proceedings under the Natural Gas Act and several national energy acts of 1978. It also has presented testimony in Congressional hearings held during the last several years in relation to current problems within the industry and possible legislative solutions.

In the aggregate, members of the UDC Group secure supplies from all interstate pipelines serving the northern and eastern sections of the United States.

All members of UDC have a vital interest in Order No. 436 and the Notice of October 9th; and UDC has fully participated in those proceedings since their inception.

APPENDIX A.

MEMBERS OF UNITED DISTRIBUTION COMPANIES

Company	State	Center of Service
BATTLE CREEK GAS COMPANY	Michigan	Battle Creek
CENTRAL ILLINOIS LIGHT COMPANY	Illinois	Peoria
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY	Illinois	Quincy
CITIZENS GAS & COKE UTILITY	Indiana	Indianapolis
CITIZENS GAS FUEL COMPANY	Michigan	Adrian
CONSUMERS POWER COMPANY	Michigan	Jackson
THE DAYTON POWER AND LIGHT COMPANY	Ohio	Dayton
THE EAST OHIO GAS COMPANY	Ohio	Cleveland and Akron
EQUITABLE GAS COMPANY	Pennsylvania	Pittsburgh
HOPE GAS, INC.	West Virginia	Clarksburg
ILLINOIS POWER COMPANY	Illinois	Decatur
INDIANA GAS COMPANY	Indiana	Muncie
KOKOMO GAS AND FUEL COMPANY	Indiana	Kokomo
MICHIGAN GAS UTILITIES COMPANY	Michigan	Monroe
NATIONAL FUEL DISTRIBUTION CORPORATION	New York and Pennsylvania	Buffalo and Erie
NIAGARA MOHAWK POWER CORPORATION	New York	Syracuse and Albany
NORTH SHORE GAS COMPANY	Illinois	Waukegan
OHIO GAS COMPANY	Ohio	Bryan and Defiance
ORANGE & ROCKLAND UTILITIES, INC.	New York and New Jersey	Spring Valley
THE PEOPLES GAS LIGHT AND COKE COMPANY	Illinois	Chicago
THE PEOPLES NATURAL GAS COMPANY	Pennsylvania	Pittsburgh
RICHMOND GAS CORPORATION	Indiana	Richmond
THE RIVER GAS COMPANY	Ohio	Marietta
ROCHESTER GAS AND ELECTRIC CO.	New York	Rochester
SOUTHEASTERN MICHIGAN GAS CO.	Michigan	Port Huron
UNION ELECTRIC COMPANY	Missouri and Illinois	Jefferson City and Alton
WEST OHIO GAS COMPANY	Ohio	Lima
WISCONSIN FUEL AND LIGHT CO.	Wisconsin	Manitowoc
WISCONSIN GAS COMPANY	Wisconsin	Milwaukee
WISCONSIN NATURAL GAS COMPANY	Wisconsin	Racine
WISCONSIN SOUTHERN GAS COMPANY	Wisconsin	Lake Geneva

Senator NICKLES. Thank you very much, Mr. Cooper, for your comments.

Our next panelist we have is Robert Loch, senior vice president, Southern California Gas Co.

STATEMENT OF ROBERT M. LOCH, SENIOR VICE PRESIDENT, SOUTHERN CALIFORNIA GAS CO., LOS ANGELES, CA

Mr. LOCH. Mr. Chairman, Senator Ford, thank you for the opportunity to give you our views on Order No. 436.

The most important element of the FERC's recent rulemaking, Order 436, is the provision relating to nondiscriminatory access to pipeline transportation of gas on behalf of distribution companies and end-users. The paramount importance of pipeline transportation has been blurred by the controversy surrounding the proposed block billing mechanism and the lack of so-called problem contract relief.

Transportation by interstate pipelines on behalf of distributors and end-users has enhanced competition in natural gas markets, and this has resulted in substantially higher volume sales at lower per unit costs. SoCal gas, for example, through its purchases of spot market gas, which is transported to California by its major interstate pipeline suppliers, we have been able to reduce our gas purchase costs by approximately $50 million in the last 4 months by substituting lower cost spot gas for pipeline purchases.

Additionally, the competitive pressure brought about by low-cost spot gas has resulted in pipeline rate reductions of approximately $200 million annually in addition to the $50 million saving. In effect, we already have some of the projected benefits of the block billing concept.

Now contrary to earlier statements by members of the first panel, lower gas costs are passed through to consumers, as Senator Ford was wondering. There were statements made there about the residential rates in Boston, and I'm not informed on that. In the case of our company, the cost savings are passed through. Mostly they are going to the industrial users, however. They bore the brunt of the rapid runup of gas costs a few years ago. They're getting the first benefits of the break in the gas prices now, and we have to pass those savings to them in order to keep them purchasing gas rather than using fuel oil. That's in the interests of producers, too.

In general, we fully support voluntary gas transportation, and in particular the concept that underlies Order 436. We, however, are urging FERC to allow more time for pipelines to elect to become nondiscriminatory transporters under this order. Further time is necessary for the Commission to consider modifications, especially those which might bolster the pipeline's bargaining power vis-a-vis the producers.

Consistent with Order 436, the California Public Utilities Commission just 8 days after FERC issued its final rule, issued a proposed transportation order which will require California distributor utilities to transport on behalf of their customers. SoCal gas supports the PUC's transportation order, and we're on record as having urged the PUC to implement transportation tariffs for the last 1½ years.

The natural gas industry is in the process of revolutionary change. Transportation will bring additional market pressures to bear on all segments of the industry, and participants will have to adjust to a changing environment. What is needed now is time for recent major structural changes to work their way through the system. It has only been 6 weeks since FERC issued its landmark 800-page final rule. Applications for modifications were filed just 2 weeks ago. The block billing concept remains only a proposal. No one expects a gas shortage, at least in the next several years.

Gas is flowing to southern California at lower costs than last year, and in full pipelines. A larger market for gas is the solution to the gas surplus. Further legislation at this time is unnecessary and would only obstruct the constructive evolution now underway in the gas industry.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Loch follows:]

STATEMENT OF
ROBERT M. LOCH, SENIOR VICE PRESIDENT
SOUTHERN CALIFORNIA GAS COMPANY

My name is Robert M. Loch. I am Senior Vice President of Southern California Gas Company (SoCalGas) the nation's largest natural gas distributor. Thank you for the opportunity to testify on Order No. 436, recently issued by the Federal Energy Regulatory Commission (FERC).

The most important aspect of the FERC recent rulemaking, Order No. 436, is the provision relating to non-discriminatory access to pipeline transportation of gas on behalf of distribution companies and end-users. The paramount importance of pipeline transportation has been blurred by the controversy surrounding the proposed block billing mechanism and the lack of so-called "problem" contract relief.

Transportation by interstate pipelines on behalf of distributors and end-users has enhanced competition in natural gas markets which has resulted in substantially higher volume sales at lower per unit cost.

SoCalGas, for example, through its purchase of spot market gas which is transported to California by its major interstate pipeline suppliers has been able to reduce its gas purchase costs by approximately $50 million in the last four months by substituting lower-cost spot gas for pipeline purchases. Additionally, the competitive pressure brought about by low-cost spot gas has resulted in pipeline rate reductions of approximately $200 million annually. In effect we already have the projected benefit of a block billing concept.

SoCalGas, in general, fully supports voluntary gas transportation and, in particular, the concept underlying Order No. 436. SoCalGas, however, urges the FERC to allow more time for pipelines to elect to become non-discriminatory transporters under Order No. 436. Further time is necessary for the FERC to consider modifications -- especially those which might bolster the pipelines' bargaining power.

Consistent with the FERC's Order No. 436, the California Public Utilities Commission (CPUC) just eight days after FERC issued its final rule issued a proposed transportation order which will require California utilities to transport on behalf of their customers. SoCalGas supports the CPUC's proposed transportation order and is on record as having urged the CPUC to implement transportation tariffs for the last year and one-half.

The natural gas industry is in the process of revolutionary change. Transportation will bring additional market pressures to bear on all segments of the industry, and participants must adjust to the changing environment. What is needed now is time for recent major structural changes to work their way through the system. It has only been six weeks since the FERC issued its landmark 800-page final rule. Applications for modifications were filed just two weeks ago. The block billing concept remains as a proposal. No one expects a gas shortage at least in the next several years. Gas is flowing to southern California at lower cost than last year. Further legislation at this time is unnecessary and would only obstruct the contructive evolution of the industry.

Senator **Nickles**. Thank you, Mr. Loch. We appreciate your comments.

Our next panelist we have is Stephen Gardner, senior counsel for AMAX, representing the National Association of Manufacturers.

STATEMENT OF STEPHEN K. GARDNER, SENIOR COUNSEL, AMAX INC., REPRESENTING THE NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. **Gardner**. Good afternoon, Mr. Chairman, and Senator Ford. I am Stephen Gardner. I am senior counsel for AMAX. I appear here today on behalf of the National Association of Manufacturers.

Mr. Chairman, I would like to have the statement already submitted included in the record of this hearing. In the interests of time, I would like to briefly summarize for this committee NAM's position.

NAM strongly supports the concept of open transportation, but we are concerned with the conditions imposed by the FERC in Order No. 436 as preconditions to obtaining open transportation uncertain or so confusing that rather than enhancing already existing transportation opportunities, it may eliminate them at least in the short term all together to the distriment of all gas users.

At the same time, NAM strongly opposes the concept of block billing. Block billing will raise the price of gas to industrials, and indeed ultimately to all consumers wherever situated without any compensating long-term benefit. Indeed, we are firmly convinced that the net impact of block billing will be extremely detrimental to the long-term reliability of natural gas supply. We remember all too well the dire gas emergencies of the 1970's with insufficient supplies, plant closings, and economic displacement, all resulting from Federal regulatory management or mismanagement of our gas supply.

With the demonstrated failing of FERC-administered controls to provide secure and reliable supplies of gas, Congress interceded enacting the NGPA, creating incentive prices to evoke new supplies, and attempting to create a new regulatory framework within which all users could be assured of adequate gas supply for the future.

Those mechanism appear to be working. Producers responded with new drilling efforts, and we presently have a market environment of large gas surpluses, declining gas prices, and a workable spot market. But rather than attempting to fine tune the existing framework, the FERC has apparently decided it is now time, notwithstanding the mandate of Congress in enacting the NGPA, to return to the failed days of the past and, by the back door, impose its own new scheme of total regulation of the price of gas.

No less than the pre-NGPA experience, we believe this latest attempt is foredoomed to failure. Block billing in no way addresses the problem of the gas cushion. It merely seizes the cushion from the pipelines and shifts it to the local distributors. But a simple shifting does not solve the problem at all.

For industrials the result of this shifting can be particularly disastrous. For the first time, the gas costs of the local distribution companies will be broken into high-cost gas and into low-cost gas.

We do not have to be clairvoyant to foresee that many State utility commissions will be tempted to assign all the low-cost gas to the residential user, and leave the industrial user with the high-cost gas.

This in turn means that industrials, if they can continue operating, either have to absorb higher gas costs, or seek out alternative fuels. Either way, it means our gas costs will go up and become less competitive in the national and international marketplace, a loss in competitiveness that our industry in this time of recordbreaking balance-of-payment deficits and resulting plant closings can ill afford.

As part of my duties for AMAX, I've had firsthand experience with what these increased costs mean. AMAX is in the mining industry, one of the most depressed industries in this country, and one that faces intense foreign competition. I'm responsible for coordinating our companywide efforts to lower our energy costs. My work is particularly important because under these current economic conditions, the absence of lower cost supplies in energy, in the absence of this, a particular mine or plant could have to be shut down. And when we shut down a plant, or when we shut down a mine, domestic workers wind up unemployed, domestic production is lost, and the Nation and its industrial base as a whole is the loser.

Equally important, the residential customers served by our supplier sees his gas price for heating go up because our contribution to the cost of operating the distribution system disappears. But our concern is also longer term.

We are finding economic supplies of natural gas available to us, but drilling is down, and we recognize that we are in part living off the current gas surplus without replacing it. Block billing will only aggravate this trend, severely reducing cash flow to producers, and leading us back down the feast-to-famine road where we will once again be confronted with natural gas shortages resulting from shortsighted, ill-founded programs.

If we are to alleviate the current problems, it lies not with the concept of block billing. If the gas cushion is the major problem, then simply shifting the cushion from one entity to another does not solve that problem. Rather, the solution lies in eliminating the cushion, and that involves allowing all gas to be sold at market clearing levels.

We appreciate this opportunity, Mr. Chairman. Thank you.

[The prepared statement of Mr. Gardner follows:]

TESTIMONY OF
THE NATIONAL ASSOCIATION OF MANUFACTURERS

BY

Stephen K. Gardner

AMAX Inc.

BEFORE THE

SENATE ENERGY AND NATURAL RESOURCES COMMITTEE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

FERC RULE ON NATURAL GAS PIPELINES

NOVEMBER 21, 1985

Mr. Chairman, Members of the Committee, I am Stephen K. Gardner, Senior Counsel for AMAX Inc. I am testifying today on behalf of the National Association of Manufacturers (NAM) as a member of the NAM Energy Committee's Fossil Fuels Task Force.

I am accompanied by Richard Seibert, Vice President, Resources & Technology Department and Jana Oakley, Director of Energy for NAM. NAM is a voluntary business association of more than 13,000 corporations, large and small, located in every state. NAM membership ranges in size from very large to over 9,000 smaller manufacturing firms, each with an employee base of less than 500. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

Natural gas is a major source of energy in the American economy. American industry is the single largest consumer of natural gas in the nation. It is important to note that industry is heavily reliant on natural gas, particularly in feedstock process and boiler applications, and consumes about 40 percent of all natural gas used in the United States.

The price, supply and transportation of natural gas is vitally important to the future growth and competitiveness of American industry. It is imperative to the industrial user that the natural gas market provide continued adequate supplies of natural gas at reasonable prices governed by the free market. Without such assurances, the industrial user would be forced to seek alternate energy sources or perhaps shut down operations.

The NAM commends the Federal Energy Regulatory Commission (Commission) for undertaking measures in seeking a more competitive natural gas market and supports the Commission's basic goal. We applaud their efforts in taking the lead in restructuring the natural gas system to achieve a more competitive market for all segments of the natural gas industry. We are particularly supportive of the rule in addressing nondiscriminatory transportation services for industrial end-users. However, the NAM expresses its strong opposition to the concept of "block billing" of natural gas. We believe block billing would not eliminate market distortions resulting from continuing natural gas production price regulation. It would instead pose a serious threat to the continued availability of dependable supplies of natural gas to industrial end-users.

Unfortunately, the rules proposed by Commission are designed to force an artificial drop in gas prices, which, in our opinion, will lead to future gas shortages without regard to our nation's energy security, without regard to the impact on competiton, and without regard to Congressional intent in passing the Natural Gas Policy Act of 1978 (NGPA).

The NGPA purportedly established a system of "incentive" pricing which conclusively presumes the existence of "rolled in" pricing. Under rolled in pricing, the controlled price of old flowing gas is averaged with the price of certain new and more costly gas supplies in attempt to eliminate price distortions in arriving at an average price of gas. Under the NGPA, producers were granted an incentive by the Congress to go out and drill new wells.

The proposed block billing program incorrectly targets the current practice of rolled-in pricing as the cause of market distortions. It simply ignores the underlying source of distortions which is lack of total deregulation of natural gas prices.

NAM realizes that market distortions do, in fact, exist with the "rolled-in" price procedure. However, the block-billing procedure will not eliminate these distortions. It will create an even greater distorted market and will send artificial signals to the market regarding natural gas supplies. Since some people will be receiving low cost gas and some higher cost gas, the demand for natural gas will vary greatly.

The Commission now proposes to greatly modify the averaging or rolled in pricing in favor of an unproven and untested concept referred to as block billing.

The revised proposal, transferring pipelines' cushions intact to local distribution companies (LDCs) would only result in new market distortions. The cushion problem will not simply go away. Under the proposed Part D, the LDCs would be given the opportunity to misuse the cushion as each state public utility commission and local distribution company sees fit. This could result in 51 different ways for allocation of "old" and "new" gas to consumers.

NAM is concerned that under the block billing procedure, the industrial end-user will not have competitive access to "old" gas. The benefit from block billing obtained by any customer is uncertain and is dependent upon each state regulator's policies. Furthermore, the price a customer pays for gas will depend upon the amount of "old" gas purchased by that pipeline's other historical customers. This certainly results in unfair price discrimination for the industrial end-user.

On October 9, 1985 the Commission issued new transportation rules intended to encourage pipelines to sign contracts to carry gas from producers' wells to gas users, such as industries and local gas utilities. Pipelines normally buy gas from producers and resell it to users, who often have no other practical source of gas. Under "contract-carriage," however, gas users can shop around for the cheapest supplies and pay a pipeline to deliver it.

Most pipelines have been delivering inexpensive contract-carriage gas to large factories for some time under Commission "blanket" transportation certificates and other programs, to avoid losing those customers entirely to other fuels. Commission contract-carriage programs that allowed pipelines to discriminate among their customers were struck down in federal court earlier this year and ordered to end by October 31, 1985.

The October 9 Commission rules replace the nullified transportation programs with a voluntary, nondiscriminatory program beginning December 15, 1985. Pipelines that sign up for the new program must offer the same contract-carriage terms to all their customers. If they don't sign up, the only way they can transport gas under contract carriage is to apply for case-by-case Commission certificates, which are subject to long reviews.

Pipeline companies charge that the new Commission contract-carriage program is tilted against them, because it allows gas utilities and other customers to unilaterally cut the amount of gas they have contracted to buy from pipelines and convert those sales to contract carriage.

As a result, only a few of the 16 major interstate pipelines have signed up for a 45-day interim, nondiscriminatory contract-carriage program that started November 1. Without pipeline participation, as much as 40 percent of spot-market gas can no longer be sold, some gas marketers have estimated. In addition, many industrial contract-carriage customers are being forced to switch to expensive pipeline gas, switch fuels or even shut down.

Local gas utilities with contract-carriage arrangements in effect before October 9 are in no immediate danger of losing their inexpensive gas, because the Commission voted to "grandfather" those contracts for up to two years. But many other producers and gas users are facing extreme difficulty.

The Commssion says its new gas regulations are intended to make the gas industry more responsive to market forces. However, Order 436 has caused industry confusion and more importantly money that could be spent on improving the natural gas situation, instead of hindering it. For example, a company reportedly spends approximately $20,000,000 per year for natural gas primarily for boiler purposes. One of the plants is on an intrastate self help program and one is on a 45 day extension of 234B gas. However, other plants lost transportation on October 31, 1985, because their pipeline did not sign on to transport gas under Order 436. Lost transportation service is costing the company $3,600 per day for every day of interruption.

In addition to the problem of non-participation of pipelines in Order 436, several local distributors have placed volume restrictions of greater than 5 million cubic feet per day per location in order to participate in contract natural gas programs. This essentially restricts gas to large companies.

The economic consequences of users being denied access to available, competitively priced gas can be profound, and the annual costs to individual industrials can easily run into the millions of dollars. The American Iron and Steel Institute estimated that the steel industry alone could save one quarter of a billion dollars ($250,000,000) if it were afforded nondiscriminatory access to transportation services for gas purchased directly from producers.

Mr. Chairman, the NAM recognizes that the transportation problems experienced now for natural gas industrial end-users will not magically disappear after December 15. The Commission contends that the pipelines will eventually be forced to comply with Order 436 transportation of gas. The pipelines contend that they will not sign on to a program which provides no incentives and, in fact, hinders their industry by not providing contract relief for high priced contracts. Unfortunately, the industrial end-user is caught in the middle. The NAM is trying to work through its membership of industrial end-users, producers, pipelines and distributors to encourage an equitable transportation program for all segments of the natural gas industry.

In closing, NAM believes that the free-market, rather than the federal government, is the most efficient allocator of energy resources. NAM strongly supports comprehensive reform of natural gas policy and supports the following principles:

- Price decontrol. Total decontrol of the wellhead price of all natural gas in an orderly manner;
- Contract Carriage. Establishment of nondiscriminatory mandatory contract carriage for natural gas based upon presumed pipeline capacity consisting of the reasonably foreseeable needs of ~~present~~ customers;
- Equal Access. Insure that all buyers have equal access to all supplies of natural gas;
- Demand Constraints. Repeal of incremental pricing and removal of mandatory demand contraints within the Powerplant and Industrial Fuel Use Act which limit flexibility;
- Excise tax. NAM opposes an excise 'windfall profits' tax on natural gas which would reduce the positive effects of decontrol.
- Public lands. Make public lands available for development in an orderly and reasonable manner.

Only through the above stated comprehensive reform of natural gas policy can the market force govern natural gas prices which will truly reflect the supply and demand of natural gas.

We appreciate the opportunity to present our views on this issue.

Senator NICKLES. Mr. Gardner, thank you very much.

Our next panelist is Mr. David Hawk, director of Energy Management Services with the J.R. Simplot Corp., Northwest Industrial Gas Users Association of Boise, ID.

STATEMENT OF DAVID H. HAWK, DIRECTOR, ENERGY MANAGEMENT SERVICES, J.R. SIMPLOT CO., ON BEHALF OF THE NORTHWEST INDUSTRIAL GAS USERS, BOISE, ID

Mr. HAWK. Thank you, Senator Nickles and Senator Ford. It's an honor to appear before you this afternoon.

I am representing, as vice chairman, the Northwest Industrial Gas Users, which are headquartered near Portland, OR, and also the J.R. Simplot Co.

By way of a possibly necessary explanatory statement of experience, let me say, Senator Nickles, I'm a native of Duncan, OK, a geologist by education, and have worked in or with virtually every phase of the oil and gas industry, with the exception of petrochemicals.

Senator NICKLES. That speaks well for you.

Mr. HAWK. Thank you. My dad would think so. [Laughter.]

The J.R. Simplot Co. is an agribusiness company with nearly 10,000 employees throughout the Western United States and Canada. The company is involved in food processing, especially potatoes, the manufacture of agricultural fertilizers, cattle feeding, ethanol production, and related businesses.

The Northwest Industrial Gas Users is an association of 26 industrial users of natural gas with major facilities located in Oregon, Washington, and Idaho. The members represent broad industrial interests which would include pulp and paper, wood products, food processing, aluminum, steel, chemicals, electronics, and aerospace.

The purpose of this testimony is to acquaint you with the efforts of the Northwest Industrial Gas Users, and in particular the J.R. Simplot Co., in transporting self-help gas into the Northwest and to advise you of our position regarding FERC's Order 436 and some problems we are having dealing with it.

We understand that FERC did not cut off transportation, but rather the interstate pipelines have. The FERC just outlined how transportation could take place, given the court rulings in the *Maryland People's Counsel* case. In fact, we need some—if in fact we need some tradeoffs between the participants, let's get together again and devise them now. We need some inventive thinking such as the Northwest Pipeline, for instance, coming up with a displacement rate which included 24 cents to compensate for the take-or-pay relief necessary that they would incur as a result of someone carrying on their system removing displacement sales, or displacing sales.

The Northwest Industrial Gas Users strongly support the new direction of FERC and filed supportive comments. Most of Order 436 will provide greater flexibility to respond to the needs of today's energy market. The transition period is, unfortunately, difficult and is yielding results at odds with FERC's goals for the nondiscriminatory transportation proposal.

The problem faced by many industries in the Northwest occurred not with the October 9 Order 436 as originally published which appeared to allow a window during which one could complete existing transactions or execute new agreements. Instead, the problem is with the technical adjustment which made the date for grandfathering transportation agreements retroactive to October 9. The November 1 deadline for grandfathered contracts would have allowed an orderly, although still rushed, transition. It would have placed industries on an equal footing, as well as local distribution companies.

Prior to October 9, a number of our Northwestern Industrial Gas Users companies were just preparing transportation agreements, or were waiting for gas to commence flowing from Northwest Pipeline System's released supplies. You see, Northwest Pipeline, which is a Williams Co. subsidiary, is the only carrier in the Northwest, and for the first time, effective May 1 of this year, placed rates into effect and agreed to carry gas for end-user sales that might displace the sale of systems gas.

Before that date, their only endeavor in transportation for end-users was purely for ammonia manufacturing and related fertilizer uses, and all that was done under section 7(c) certification. Since May, Simplot had been working with brokers, producers, pipelines, and our local distribution companies to move gas to our facilities in Idaho and Oregon.

We experienced numerous delays. In Idaho, Intermountain Gas had rates in place. In Oregon, our local distribution company didn't get a full schedule of rates in place until early September of this year. In mid-September, Simplot had transportation in place and was moving gas to our plants in Idaho. Contracts with our supply sources were set to expire at the end of October for several reasons.

No. 1, our supply sources might be needed for the fall heating season.

No. 2, FERC's new rules would be out November 1.

No. 3, Canada was expected to announce a new gas pricing policy the first week in November.

No. 4, in Idaho the public utility commission was set to rule in late October on an Intermountain Gas rate case which could substantially lower industrial user gas costs.

Simplot had been, since late summer, negotiating independently and with Intermountain Gas to find lower cost gas for our needs and those of our local distribution company. At a time when prices were going down and the uncertainty of the above four items was such we considered it prudent business to hold off finalizing an arrangement until we were close to the date when we could use the gas and know how much we needed for sure.

Negotiations were clearly well underway by October 9 to accomplish those ends that we could put into effect November 1. The imposition of the October 9 cutoff placed into effect on October 24 has cost significant disruption in what seemed to be a realistic plan for acquisition of transportation of gas.

The October 9 cutoff frustrated proposed transportation that was basically concluded October 24 and appeared to be an outstanding example of cooperation between an LDC and an end user which would mean substantial savings for all the gas customers in southern Idaho. Producers in Wyoming wanted to sell. Colorado Interstate wanted to transport. Northwest was willing to transport. And Intermountain and Simplot were ready to use the gas.

These efforts embodied the concepts espoused by FERC in encouraging cooperation and nondiscriminatory transportation. Due to the technical adjustment date revision, the project died leaving Simplot in serious jeopardy concerning an economical supply of natural gas for feedstock for use at our amonia production facility, depending now on the processing and approval of a 7(c) application filed on our behalf by Northwest and CIG.

We appreciate the best efforts and the past efforts of CIG, Northwest Pipeline, and Mountain Fuel. However, in the future if Rocky Mountain Pipelines do not provide nondiscriminatory transportation, we in the Northwest will be at a disadvantage with Midwest and Southern areas where pipeline competition more easily will occur.

In closing, the natural gas is important in the Northwest Industrial Gas Users, many of whom can switch to coal. The Northwest Industrial Gas Users encourage you to take any steps you may deem necessary to further the creation of an open and competitive marketplace for natural gas.

There are, we believe, combinations of options that can be useful and can satisfy the needs of everyone if we'll sit down and put them together. Thank you.

[The prepared statement of Mr. Hawk follows:]

TESTIMONY PRESENTED BY

DAVID H. HAWK
DIRECTOR, ENERGY MANAGEMENT SERVICES
J.R. SIMPLOT COMPANY
BOISE, IDAHO

ON BEHALF OF
THE NORTHWEST INDUSTRIAL GAS USERS
AND
THE J.R. SIMPLOT COMPANY

My name is David H. Hawk, I am the Director of Energy Management Services of the J.R. Simplot Company and serve as the Vice Chairman of the Northwest Industrial Gas Users.

The J.R. Simplot Company is an agribusiness company with nearly 10,000 employees throughout the western United States and Canada. The company is involved in food processing, the manufacture of agricultural fertilizer, cattle feeding and several other agribusiness enterprises.

The Northwest Industrial Gas Users is an assocation of 26 industrial users of natural gas with major industrial facilities located in the States of Washington, Oregon, and Idaho. The members of the Northwest Industrial Gas Users represent broad industrial interests including pulp and paper, wood products, food processing, aluminum and steel, chemicals, electronics and aerospace.

The purpose of this testimony is to acquaint this Senate Subcommittee with the efforts of the Northwest Industrial Gas Users Association, of which the J.R. Simplot Company is a member, to bring self-help gas into Idaho, Washington, and Oregon for use at their plant facilities. Further, it is our intent to advise you of our position regarding FERC order #436 concerning Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol under Docket No. RM85-1-000.

Northwest Industrial Gas Users strongly supports the new direction of the Federal Energy Regulatory Commission and filed supportive comments in Docket No. RM85-1-000.

We believe Order No. 436 will provide greater flexibility to respond to the changing needs of today's energy market. The Commission's emphasis and reliance on the operation of competitive market forces, with the attendant risks and opportunities, will ultimately be of most benefit to the natural gas system and the different classes of customers it serves.

Unfortunately, as often happens with sweeping new programs, the transition period can be difficult, and yielding results at odds with the ultimate goals of the program. FERC outlined a nondiscriminatory transportation program consistent with D.C. Court of Appeals ruling in the Maryland's Peoples' Counsel case. The problem, faced by many industries in the Northwest, occurred, not with the October 9, 1985, regulation (Order No. 436) which, as originally published, appeared to allow a "window" during which one could complete existing transactions or execute new agreements. Instead, the problem is with the October 24, 1985, "technical adjustment" which made the date for "grandfathering" of agreements retroactive to October 9, 1985. A November 1, 1985 deadline for "grandfathered" contracts would have allowed an orderly, although still rushed, transition.

A number of our members were just preparing transportation arrangements. In the spring of 1985 Northwest Pipeline, the only interstate carrier in the Pacific Northwest, for the first time agreed to carry gas for end-user sales that might displace the sale of system gas. Its rates became effective May 1, 1985.

The J.R. Simplot Company's experience is illustrative of the situation in the Northwest. The J.R. Simplot Company has been transporting natural gas under FERC "7(c)" certificate since 1982, from New Mexico as feedstock for its ammonia facility in Pocatello, Idaho. The purpose was to keep the production costs of ammonia competitive with imported ammonia. Although low cost natural gas has been available over the past three years and Intermountain Gas Company, Simplot's local distribution company, has had transportation rates in place, we were unable to take advantage of the non-ammonia transportation rate because, Northwest Pipeline until May 1, 1985, would not carry gas for any end-user on utilities' systems in the Northwest unless it was purely for ammonia and related uses.

Since May we have been working with producers, brokers and pipelines to move gas from the field to our facilities in Idaho and Oregon. In addition we have been moving gas from Oklahoma to a potato processing plant in Grand Forks, North Dakota, since September. In June and July, Simplot had contracts in place for the movement of gas to plants in Idaho with Northwest Pipeline as the transporter. Contracts with supply sources were set to expire the end of October for several reasons. First, supply sources might need the gas for the fall heating season; second, the FERC was due to release the new rules for transportation on November 1; third, Canada was expected to announce new gas pricing policy in early November; and last, the Idaho Public Utilities Commission was expected to rule on Intermountain Gas Company's pending rate case late in October or early in November.

Simplot had been negotiating since that time independently and with Intermountain Gas Company to find lower priced sources of gas for both Simplot's needs, and the needs of Intermountain Gas Company's industrial, commercial and residential customers. The goal was to secure the lowest price natural gas with the greatest reliability of delivery. At a time when prices were going down, we considered it to be prudent business practice to hold off concluding any arrangement until Simplot was close to the date the supply was needed. Arrangements had been made through October 31, 1985 and negotiations were in progress for extensions and new sources that would take effect November 1, 1985.

It was the imposition of the October 9, cutoff on October 24 that has caused significant disruption to what had seemed to be a realistic and prudent plan for acquisition and transportation of gas. The October 9 cutoff was particularly frustrating in a proposed transaction that, until October 24, 1985, appeared to be an outstanding project resulting in substantial savings to the people of the State of Idaho. The proposed venture would have allowed Simplot and the customers of Intermountain Gas Company to take advantage of low cost gas supplies available in the market place. Producers in Wyoming wanted to sell; Colorado Interstate wanted to transport and receive its transportation fee; Northwest Pipeline was willing to transport and receive its transportation fee; Intermountain Gas Company was willing to transport and receive its transportation fee as well as deliver lower cost gas to its residential and commercial customers. These efforts embody the very concepts espoused by FERC in encouraging state regulators to provide transportation opportunities and encouraging major pipeline carriers to provide nondiscriminatory transportation for end-users.

As it now stands, the project is not dead. Colorado Interstate and Northwest Pipeline have filed for a "7(c)" certificate application on our behalf. This approach, however, leaves us in serious jeopardy concerning an economical supply of natural gas for feedstock use at our ammonia production facility in Pocatello, Idaho, while these applications are processed.

The FERC decision is particularly important in the Pacific Northwest where there has previously been no meaningful gas to gas competition. The potential for competition will ultimately benefit all types and sizes of natural gas users in the Northwest.

Being served by a single pipeline, in the Pacific Northwest, local distribution companies and end-users have no significant alternative source of natural gas except through Northwest Pipeline. Due to the configuration of the pipeline, the Northwest has been heavily dependent on Canadian gas from the

north end of the pipeline. Alternative means of securing domestic supplies are, at times, physically limited.

Staggering increases in natural gas costs in the past several years, combined with significant supplies and choices of lower-priced alternate fuels, including residual fuel oil, coal, and surplus hydroelectric power, together a stagnant economy, have produced heavy natural gas load losses over the past several years. These load losses have meant even higher gas prices to all the residential, commercial and industrial gas users remaining on the system who must share a proportionately heavier burden in paying for the cost of the pipeline and distribution systems.

The new opportunities and potential for competition can help alleviate some of these problems of the Pacific Northwest, to the benefit of all natural gas users in the region.

The availability of nondiscriminatory gas transportation service creates the potential for at least the threat of competition from direct gas purchases. The competitive pressures created by the provisions of Order No. 436 can give the pipeline added incentive to secure the lowest-priced gas possible to compete with alternative purchase arrangements. They can give local distribution companies and end-users more options in securing their own lower-priced gas supplies. They encourage both the pipeline and local distribution companies to keep costs down so as to be competitive in both sales and tranportation rates. These increased opportunities and potentially lower rates can generally benefit all natural gas users.

Furthermore, these new options, and the competitive pressures they introduce, can help regain natural gas loads lost to alternate fuels. They can help retain natural gas customers and forestall investments in additional alternate fuel capability. They can aid the economic revitalization of the region and help businesses justify capital investments in new and expanded facilities. As natural gas loads increase a fuller, more efficient use can be made of both the pipeline and local distribution company systems. The costs of these facilities are shared among more and more natural gas users, resulting in potentially lower rates for all customers.

If Rocky Mountain pipelines do not elect to be nondiscriminatory carriers, we in the Northwest, will be at a competitive disadvantage with Midwestern and Southern areas where competition already exists with numerous pipelines. We appreciate the spirit of cooperation we have received from Northwest Pipeline, Colorado Interstate, Mountain Fuel and our local distribution companies. We will continue to work with the producers and pipelines to do what is necessary to bring supplies of lower cost natural gas into the Northwest.

The Northwest Industrial Gas Users Association appreciates the opportunity to acquaint you with our experiences. We encourage you, to support and facilitate, if necessary, the FERC's steps, to further the creation of an open and competitive market place for natural gas, beginning with the broadening of transportation options. We believe there exists legitimate combinations of options that will satisfy the needs of the producers, the pipelines, and the local distribution companies.

Thank You.

Senator NICKLES. Mr. Hawk, thank you very much. I appreciate your comments.

We have a vote. If you would, Mr. Bennis, if you don't mind beginning, I will step out for a little bit, and I'll be back in just a minute. We appreciate it, and I apologize for the inconvenience.

Senator FORD [presiding]. It shows complete trust, Mr. Bennis, when the majority turns it over to the minority. [Laughter.]

STATEMENT OF WILLIAM E. BENNIS, MANAGER OF ENERGY AFFAIRS, CARPENTER TECHNOLOGY CORP., HOUSTON, TX

Mr. BENNIS. I hope so. I'm looking forward to it.

I am Bill Bennis, manager of energy affairs for Carpenter Technology Corp., Reading, PA.

Carpenter is a manufacturer of specialty metals, with our largest plants being in Reading and Bridgeport, CT. I'm here today principally representing Carpenter, and also the Process Gas Consumer Group, of which Carpenter is a member, the American Iron and Steel Institute as chairman of their Energy Committee, and the Industrial Energy Consumers of Pennsylvania.

I appreciate the opportunity to offer our views on FERC's Order 436, and in general Carpenter and the industrial groups to which it belongs are most satisfied with the FERC's order. From my perspective as energy manager, how pleasant it has been to see clearly what natural gas costs actually are. I pay the producer directly at a competitive price. I pay the interstate pipeline only for the services he provides, and we're very optimistic that in the very near future we will pay the local utility only for the services that he provides.

The economic consequences of users being denied access to available competitively priced gas can be profound. The American Iron and Steel Institute estimated that the steel industry alone could save one-quarter of a billion dollars per year if it were afforded nondiscriminatory access to transportation services.

The marketplace's need for broader transportation received a major boost on October 9, 1985, when the FERC issued Order 436 which, if it could be successfully implemented, would sharply redirect the natural gas industry towards nondiscriminatory transportation services and far greater competition than it has ever known.

Unfortunately, the very positive consumer impacts of Order 436 will not be recognized under the current situation because virtually all the major interstate pipelines are refusing to participate. Many of these nonparticipating pipelines previously were offering some transportation service to customers with alternate fuel capability. Much of this service has now been cut off, and the impact on PGC, AISI, and other industrial group companies of this denial of access by the pipelines is in many cases devastating.

Some of our member companies are currently paying in excess of $400,000 a month over what they would have been paying for gas prior to October 31 because of the need to substitute the pipeline's high priced gas for their own user-owned gas, which the pipeline now refuses to transport.

These examples do not include the large numbers of industrial, agricultural, commercial, and residential customers who were previously discriminated against by the pipelines and were never allowed to receive the benefits of open transportation, but who could have had access to lower priced gas if the pipelines would participate in the Order 436 program.

Our Reading, PA, plant is an example of the advantages of order 436 in contract carriage. Because Columbia is one of the few pipelines that has agreed to transport at least until December 15, we are paying $2.09 less per mcf for gas than having to purchase it from our local utility. In addition, the Pennsylvania Public Utility Commission has now initiated consideration of cost-based transportation rates.

If Columbia continues to participate, and if the Public Utility Commission acts favorably, Carpenter could, because of contract carriage, be paying almost 50-percent less for gas than what we paid in early 1984.

We commend the FERC for its efforts to allow a competitive gas market to operate. If FERC's efforts fail, it is the pipelines who refuse to participate on whom the blame should be placed. If Columbia fails to continue providing service after December 15, we will be required to return to the higher priced local utility gas, and the annual penalty will exceed $5 million a year for our one plant. This is a large amount for a smaller company such as Carpenter.

At our Connecticut plant it's a different situation, because we have been completely unsuccessful in our attempts to arrange transportation. The resistance of Tennessee Gas, Texas Eastern, and Algonquin Pipelines, and of the local utility have made it impossible. Our only alternative is to invest in a No. 6 oil system to allow us to burn a minimal supply of oil at peak periods.

Now if we do that, the utility will sell us gas the rest of the year at the cost of the alternate fuel, which is about 26 percent less than their tariff gas. This is certainly another example of why nondiscriminatory transportation must be expanded as Order 436 has tried to do.

In conclusion, as a result of the pipeline denial of access, available low cost natural gas is being shut in, and most consumers—large and small—are being forced to pay higher prices.

Senator FORD. Mr. Bennis, how much longer do you have?

Mr. BENNIS. Just a couple seconds.

Senator FORD. The red light is on, and I want to get the last one in before I have to leave.

Mr. BENNIS. OK. PGC, AISI, and other industrial group companies intend to pursue every remedy available to them to obtain lower access to lower priced gas supplies. We would urge this subcommittee to exercise its oversight responsibility to review most carefully the actions of the pipelines which are frustrating implementation of Order 436, and if necessary to utilize as well its legislative powers to provide nondiscriminatory contract carriage and market price gas supplies.

Thank you.

[The prepared statement of Mr. Bennis follows:]

STATEMENT OF

WILLIAM E. BENNIS

ON BEHALF OF

CARPENTER TECHNOLOGY CORPORATION
THE PROCESS GAS GAS CONSUMERS GROUP
THE AMERICAN IRON AND STEEL INSTITUTE
THE INDUSTRIAL ENERGY CONSUMERS OF PENNSYLVANIA

I am Bill Bennis, Manager of Energy Affairs, for Carpenter Technology Corporation, Reading, Pennsylvania. Carpenter is a manufacturer of specialty metals serving industries, such as, aerospace, chemical, electrical, machine tool, petroleum, power generation, and transportation. Our main steel division plants are in Reading, Pennsylvania, and Bridgeport, Connecticut.

I am here today principally representing Carpenter Technology and also the Process Gas Consumers Group (PGC), of which Carpenter Technology is a member, the American Iron and Steel Institute (AISI), as Chairman of their Energy Committee, and the Industrial Energy Consumers of Pennsylvania, as Natural Gas Chairman.

My background is engineering, mostly in the design and quality performance of reheat and heat treat furnaces, and systems that use natural gas.

The Process Gas Consumers Group is an organization of eighteen large industrial consumers of natural gas organized to promote the development and adoption of coordinated, rational, and consistent federal and state policies with respect to gas use. Representing many of the nation's basic industries, our member companies own and operate hundreds of plants in virtually every state and purchase natural gas directly or indirectly from both interstate and intrastate pipelines, with most of our facilities on the interstate system. A list of our members is included as Attachment 1.

AISI is the principal trade association for the steel industry. Its 48 domestic member companies represent 79% of the raw steel production in the United States.

I appreciate this opportunity to offer our views on the Federal Energy Regulatory Commission's (FERC) Order 436 and related matters.

I. A Call to Compete

PGC recently completed a year long review of the natural gas marketplace in which our member companies, working with outside consultants, participated. The conclusion of our review is that the interests of all involved in the natural gas industry -- producers, pipelines, distributors, end users, marketers, etc. -- will best be served by making the purchase, sale, and transportation of natural gas as market-oriented as possible. This means that regulatory authorities at all levels of government should adopt and implement policies designed to promote competition in the marketplace to the greatest extent possible. Only through such policies will gas consumers be able to obtain reliable supplies of natural gas at the lowest reasonable prices.

To advance this overall objective, PGC believes that the following strategic goals should be pursued by all interested parties -- sellers, purchasers, transporters, or regulators:

- Competition should be promoted at all levels, wellhead, pipeline, and distributor.
- Where pipelines and distributors are sheltered from competition and exercise considerable monopoly power, they should continue to be subject to regulatory oversight.
- There should be effective incentives for both pipelines and distributors to operate efficiently and with good business practices.
- All potential purchasers, including end users, should have equal access to all gas supplies, and pipelines and distributors should be obligated to transport on a nondiscriminatory basis all such gas for any potential shipper desiring such transportation.
- Rates, including transportation rates, at both the pipeline and retail levels should be unbundled and based on the cost of service.
- Curtailments of both sales and transportation services should be based on end use.

We have just issued the results of PGC's analysis of gas markets and of these goals in a document we have entitled "A Call To Compete," a copy of which is attached.

II. The Need for Non-Discrimatory Transportation Services

For the past two years, PGC, AISI and other industrial groups have pointed out, in legislative and regulatory forums including this subcommittee, that interstate pipelines and many distribution companies have tended to act as obstacles to prevent or substantially limit meaningful gas price competition within their service areas. There is ample public evidence that pipelines, and in many cases distribution companies have implemented policies to protect their own sales from competition by denying transportation services to those who would like to buy gas from competing third parties. In addition, a number of pipelines and local distribution companies have erected insuperable barriers to competition even though they have not formally announced a policy against transporting competing gas supplies.

The economic consequences of users being denied access to available, competitively priced gas can be profound. The American Iron and Steel Institute estimated that the steel industry alone could save one quarter of a billion dollars per year ($250,000,000) if it were afforded nondiscriminatory access to transportation services for gas purchased directly from producers.

We agree wholeheartedly with the statement by the Department of Energy in its Second Report to Congress that "[c]onstraints on spot market eligibility and limitations on access to pipeline capacity support discriminatory actions by pipeline companies that slow the downward adjustment of prices across all segments of the natural gas market." Department of Energy, Increasing Competition in the Natural Gas Market, January 1985, p. S-5. DOE's position favoring contract carriage is supported not only by industrial users, but also by a vast array of parties representing many different and often competing interests, including the Equal Access Group (independent producers), the NASUCA (residential consumer advocates), and the Heritage Foundation.

Nondiscriminatory carriage, including carriage for process uses, is essential to restoring and maintaining market balance and increasing gas sales competition. Such competition will give consumers and producers market options that do not exist when a handful of pipelines use their transportation monopoly power to control the purchase and sale of natural gas. Pipelines and local distribution companies should have higher overall deliveries, albeit greater competition in their role as sellers. Without expanding the opportunities for users and producers to do business directly, the system remains dependent on the buying decisions of pipelines and local distribution companies, which historically have been sheltered by regulatory agencies from economic losses from curtailments or price-induced sales declines. Sellers that are sheltered from the economic impact of marketing and supply errors cannot be expected to buy their gas supplies efficiently.

Proposals, such as those of the American Gas Association, for "voluntary" contract carriage are inherently inadequate because pipelines and distributors have shown that they will use their monopoly power over transportation to limit competition with their own sales.

Although transportation for others has expanded over the past two years, pipelines have volunteered to transport only when it suits their own interests in displacing another energy seller, and much of this transportation has been for other pipelines.

Thus, many high priority industrial and other consumers who lack economical alternate fuel capabilities have continued to be denied the opportunity to obtain the economical supplies of natural gas that should be available in the marketplace. The SMPs and other discount rate programs did little or nothing to lower prices for so-called "captive" markets or to promote the gas price competition that is badly needed to bring about voluntary contract renegotiation becauses those programs primarily focused on only 25 percent of the market -- that is, those industrial users with installed residual oil capabilities.

III. Order 436

The marketplace's need for broader gas transportation received a major boost on October 9, 1985 when the FERC issued Order 436 which, if it could be successfully implemented, would sharply redirect the natural gas industry toward nondiscriminatory transportation services and far greater competition than it has ever known. The Order is a direct outgrowth of FERC's three-phase Notice of Inquiry proceeding in Docket No. RM85-1-000, which was initiated by notices issued December 24, 1984 and January 18, 1985, and it responds to the recent decisions of the United States Court of Appeals for the D.C. Circuit which vacated portions of the Blanket Certificate and Special Marketing Programs. Maryland Peoples Counsel v. FERC, Nos. 84-1019 and 84-1090 (May 10, 1985).

In general, PGC, AISI and other industrial groups are most satisfied with the FERC's Order. We believe that FERC has acted well within its authority under the Natural Gas Act to prohibit undue discrimination and has issued a well reasoned and well supported set of regulations designed to promote competition. The new rules and analysis obviously reflect a tremendous effort by the Commission and its staff and they respond to many of the comments from the public. PGC, AISI and other industrial groups intend to work with the Commission during the months ahead to achieve the goals of a more open, market-driven pipeline system.

Generally, the blanket transportation and optional certificate regulations correspond closely with Parts A and C of the May 30 Notice of Proposed Rulemaking, although a number of significant changes have been made. In particular, the final rules incorporate a number of suggestions made by industrial gas users. For example, the new rule provides that a "reservation fee or charge" may be imposed for firm service; requires that interstate pipelines that provide firm transportation under a blanket certificate must also provide interruptible service; and clarifies that end-user transportation may be for an unlimited term once notice and protest procedures have been satisfied. Moreover, consistent with industrial users' recommendation, the Order eliminates the proposed take-or-pay "safe-harbor" provisions (Part B) as unnecessary, and it provides for expedited consideration of producer abandonment applications in certain instances. In addition the rule would, consistent with PGC, AISI and other industrial groups' recommendations, provide as follows:

Blanket Transportation Provisions

- The rule permits blanket authorizations for interstate transportation services under § 7 of the Natural Gas Act (NGA), and § 311 of the Natural Policy Act (NGPA), replacing the several existing blanket programs. Blanket authorization for interstate transportation under nondiscriminatory terms is available to interstate pipelines, intrastate pipelines, and local distribution companies (LDC's).

Eligible Customers and Supplies

- Gas from any source (including gas from the Outer Continental Shelf) may be transported to any buyer for any use (assuming other legal restrictions are met, (e.g., abandonment authority for dedicated gas)).
- Any interstate pipeline that accepts a blanket certificate under the rules would be required to offer both firm and interruptible transportation to all interested shippers on a nondiscriminatory basis, within the limits of existing capacity.

- Under the rules implementing NGPA § 311, transportation must be "on behalf of" an LDC (a statutory requirement) but may be for an individual user's account. The "system supply" requirement from previous Section 311 regulations is eliminated.

Rate Conditions

- Transportation rates in the interstate pipeline's tariff must, in general, be designed on a voluntary basis, based on representative levels of projected transported volumes, and may not include provisions to guarantee revenue, such as demand charges and minimum bills. However, a "reservation fee or charge" may be imposed for firm service.
- Interstate pipelines' transportation rates must reasonably reflect any material variations in the cost of providing service due to distinctions between peak and off-peak service or the distance that the gas is transported.
- An interstate pipeline's tariff must show (a) maximum transportation rates designed to fully recover only those costs which are properly "allocated" to the service, and (b) minimum rates based on average properly-allocated variable costs; the pipeline may vary its charges (i.e., grant "selective discounts") to individual customers within that range. The pipeline bears the risk of underrecovery of

costs and it must file a report with the Commission if it charges less than the maximum rate.

Contract Demand Reductions

- An interstate pipeline that offers transportation must allow each of its firm sales customers to reduce its contract demand (CD) or to convert to firm transportation up to 25 percent per year of its sales entitlements. Pipelines may file for abandonment of their sales obligations to the extent that distributors exercise this option. At least 150 days written notice may be given for CD reduction and the pipeline may establish a single date during each calendar year for reductions to take effect. At least 60 days notice of CD conversion is required unless the pipeline agrees otherwise. These provisions take effect on February 1, 1986, with the first CD reductions to take effect on September 1, 1986.

Optional Expedited Certificates

- For the purpose of initiating new services, expedited certificate authorization under Section 7 of the NGA is available for transportation, sales, construction or acquisition of facilities, operation of facilities and pre-granted abandonment of services.

- To be eligible for the optional procedures, a natural gas company must: a) offer non-discriminatory transportation services in compliance with the new rules; b) permit existing customers the opportunity to reduce their contract demands; and c) assume the full economic risk of the new service (primarily through the use of volumetric rates calculated using representative volumes of service).

Revised Block Billing Proposal

- As PGC, AISI and other industrial groups urged, FERC did not adopt block billing in Order 436. However, it did issue a revised block billing proposal and requested supplemental comments. PGC, AISI and other industrial groups continue to oppose block billing even in its revised form because block billing threatens to severely distort gas markets without resolving the underlying problems of continued price controls on "old" gas.

IV. Failure of the Pipelines to Participate

Unfortunately, the very positive consumer impacts of Order No. 436 will not be recognized under the current situation because virtually all of the major interstate pipelines are refusing to participate in the nondiscriminatory transportation program established by the FERC Order. For example, one nontransporting pipeline, Transco, has specifically indicated in a letter to its customers that as a matter of policy it will continue transporting gas only if the volumes do not compete with its own sales of higher priced gas.

Many of these nonparticipating pipelines previously were offering some transportation service to customers with alternate fuel capability. This service has now been cut off and the impact on PGC, AISI and other industrial group companies of this denial of access by the pipelines is in many cases devastating. Some of our member companies are currently paying in excess of $400,000 per month over what they were paying for gas prior to October 31 because of the need to substitute the pipeline's high priced gas for the user-owned gas which the pipeline now refuses to transport. Given the difficulties many PGC, AISI and other industrial group companies face with foreign competition, such cost increases serious problems. In addition, these examples do not include the large numbers of industrial, agricultural and commercial consumers who were previously discriminated against by the pipelines and were never allowed to receive the benefits of open transportation but who could have access to lower priced gas if the pipelines would participate in the Order 436 program. Nor do these examples reflect the potential savings which residential and small business consumers would realize if their local distribution companies were given nondiscriminatory access to market priced gas supplies.

From my perspective as Energy Manager for Carpenter, learning that we may lose transportation at our main plant in

Pennsylvania and, likely, never get transportation at our second largest plant in Connecticut, has stood out as a major event.

Specialty metals is a very energy-intensive business. Seventy-three percent of Carpenter's Btu requirements come from natural gas or fuel oil. Natural gas is essential for the finishing part of our process as it is the only fuel that can, technically, assure the quality our customers require. We are, therefore, extremely concerned about the supply and cost of natural gas. Supply is not the immediate problem; the cost is a serious problem if we must purchase gas from our local distribution company on the currently regulated tariff.

Our Reading, Pennsylvania plant is an example of the advantages of the Order 436 and contract carriage. In February 1984 at Reading, we paid $6.42 per Mcf from the local utility which is served by Columbia, one of the few pipelines that has agreed to participate in the transportation program at least until December 15. We are paying $4.37 this month, a 32% reduction achieved because Columbia has chosen to participate in nondiscriminatory transportation at least until December 15. We are purchasing gas at the wellhead. Over the past eight months, the cost of gas at the wellhead has dropped 26%. Market signals were sent from the user to the producer, and competition was working. The tariff rate we are paying the local utility is the same now as it was back in early 1984 and is based on gross margin, not cost of service. In addition, the Pennsylvania Public Utilities Commission has now initiated a case to fully consider cost-based transportation rates for the state. The support of contract carriage by both producers and users were factors but the real impetus came from FERC's taking the lead in the unbundling of rates for transportation services. If Columbia continues to participate and the Public Utility Commission acts, Carpenter could, because of contract carriage, be paying almost 50% less than what we paid in early 1984 for natural gas at Reading.

This example clearly demonstrates that competition, unbundling of rates, and cost of service are possible, and we commend the FERC for its efforts to allow a competitive gas market to operate. If FERC's efforts fail, it is the pipelines who refuse to participate on whom the blame should be placed. If Columbia fails to continue providing service after December 15 we will be required to return to the local utility owned gas at the Reading Plant and the annual penalty will exceed $5 million, a large amount for a smaller company such as Carpenter.

At our Connecticut plant, it is a different situation because we have been completely unsuccessful in our attempts to arrange transportation. The resistance of Tennesee Gas, Texas Eastern, and Algonquin pipelines and of the local utility have made it impossible. Our only alternative is to invest in a #6 oil system to provide us a minimal supply of oil at peak periods. Only if we do that will the utility sell us gas for the rest of the year at the cost of the alternate fuel that is now about 26% less than their tariff gas. This Connecticut situation is another illustration of why nondiscriminatory transportation with unbundled cost-based rates from the wellhead to the burner tip must be expanded, as Order 436 has tried to do.

In conclusion, as a result of the pipeline's denial of access, available low cost natural gas is being shut in and most consumers, large and small, are being forced to pay higher gas prices. As users, we are greatly concerned what impact this will have on future gas supplies and the the exploratory efforts of producers, particularly the independent producers who face an uncertain future without open access to markets.

Thus, PGC, AISI and other industrial groups are faced with a situation where low priced natural gas is being taken off the market and high monopoly prices are being charged, in spite of the excellent effort by the Federal Energy Regulatory Commission in Order 436 to install badly needed competition into interstate natural gas markets. PGC, AISI and other industrial group companies intend to pursue every remedy available to them to obtain access to lower priced gas supplies. We would urge this Subcommittee to exercise its oversight responsibility to review most carefully the actions of the pipelines which are frustrating implementation of Order 436 and if necessary to utilize as well its legislative powers to provide nondiscriminatory contract carriage of market priced gas supplies. We look forward to working with the Subcommittee on all of these matters and we will be pleased to respond to any questions that you may have.

November 21, 1985

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Eaton Corporation

Ford Motor Company

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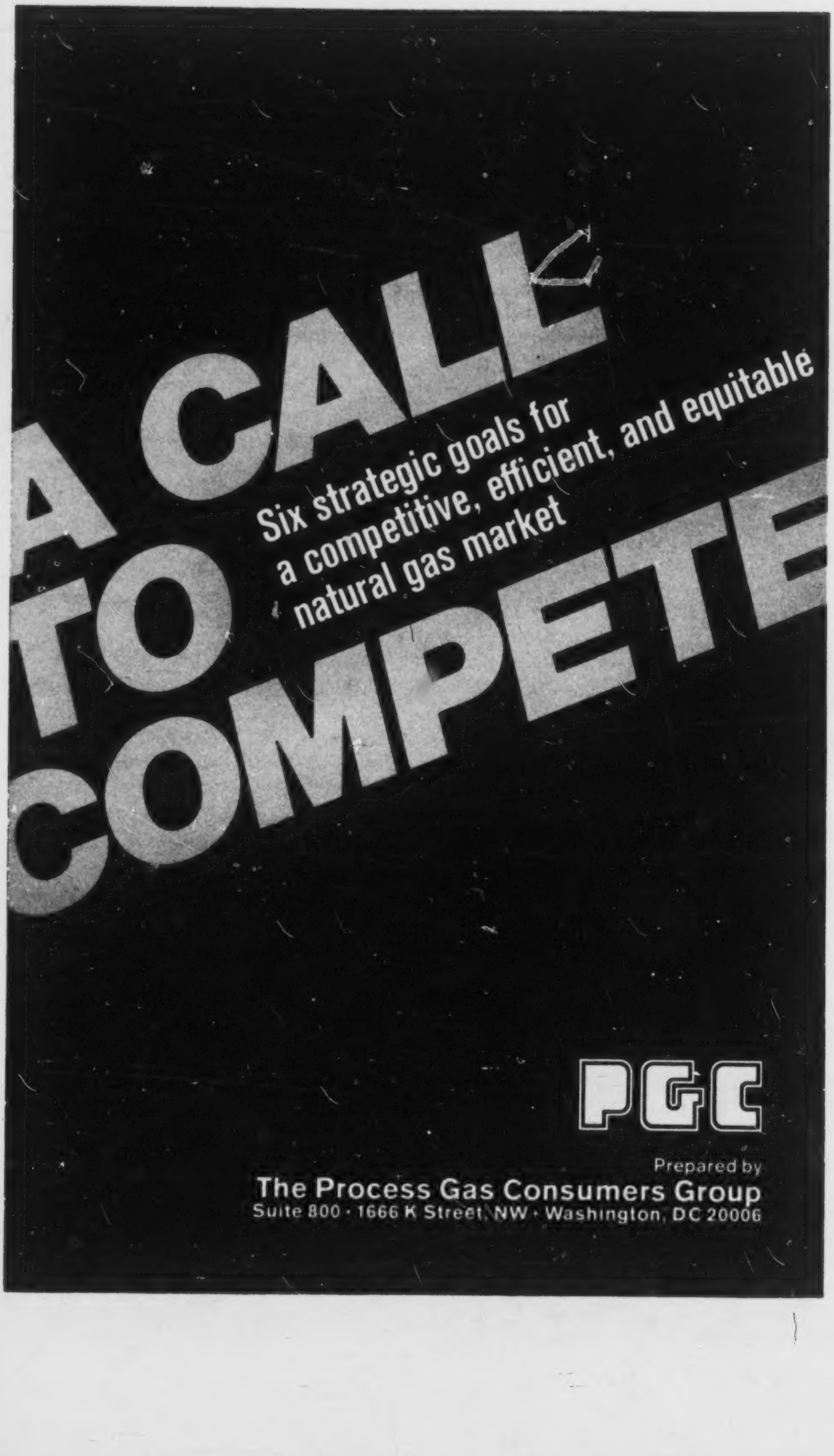
Hershey Foods Corporation

LTV Steel Company

Owens-Corning Fiberglas Corporation

Owens-Illinois, Inc.

Attachment 1



A CALL TO COMPETE

Six strategic goals for
a competitive, efficient, and equitable
natural gas market

PGC

Prepared by
The Process Gas Consumers Group
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INTRODUCTION

The Process Gas Consumers Group (PGC) believes that the interests of all involved in the natural gas industry—producers, pipelines, distributors, end users, marketers, etc.—will best be served by making the purchase, sale, and transportation of natural gas as market-oriented as possible. This means that regulatory authorities at all levels of government should adopt and implement policies designed to promote competition in the marketplace to the greatest extent possible. Only through such policies will gas consumers be able to obtain reliable supplies of natural gas at the lowest reasonable prices.

To advance this overall objective, PGC believes that the following strategic goals should be pursued by all interested parties—sellers, purchasers, transporters, or regulators.

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STRATEGIC GOAL NO. 1

Competition should be promoted at all levels, wellhead, pipeline, and distributor.

Promotion of competition is PGC's key strategic goal. PGC believes that only through the operation of competitive forces can all consumers, including industrial end users, be assured of adequate supplies of gas at the lowest reasonable price. Market forces can do a much better job than any governmental agency in arriving at prices for a commodity such as gas. If competition is encouraged at all levels of the gas industry, all will benefit. Prices to consumers will not exceed market levels; producers will have more opportunities to sell their gas to the many available markets; and pipelines and distributors will have greater opportunity to maximize the efficient utilization of their systems.

At the wellhead, the best way to assure a competitive marketplace is to promote access to the field by multiple sellers and buyers. There is no better way to communicate correct price signals to producers than to give multiple sellers and buyers direct access to one another. Of course, such access will be meaningful only if the buyers can move the gas they buy to the places they wish to use or resell it. This means that producers must have adequate access to pipeline facilities. One way to assure such access is to encourage the availability in a producing field of more than one pipeline system, thus creating competitive pressure on pipelines to make transportation services available.

At the pipeline level, competition can and should be encouraged in two ways. To the greatest extent possible, each market area should be served by more than one pipeline, and customers should be given flexibility to choose among the available pipelines. This means that commodity minimum bill or minimum physical take requirements in pipeline sales tariffs should be eliminated. With adoption of rate designs which appropriately collect all fixed costs in the demand component, this becomes feasible. In addition, gas-on-gas competition at the pipeline level should be encouraged by requiring pipelines to provide transportation services for gas owned by distributors or end users.

Finally, at the distributor ("LDC") level competition can and should be promoted in at least two ways. First, LDC's should be encouraged to obtain multiple sources of gas, either from competing pipelines or from producers, marketers, etc. Second, each LDC should itself be subject to competition from gas purchased by its own customers from third parties and transported at unbundled, cost-based rates through the LDC's system. Finally, subject to appropriate controls and safeguards, customers of LDC's should have the right to direct connection with an alternate pipeline or LDC.

Partial deregulation at the wellhead and increased competition in the gas marketplace have increased the potential for market forces to operate on a broad basis. It is now up to regulatory authorities at both the federal and state levels to adopt policies and take concrete steps to promote competition at all levels of the gas industry.

STRATEGIC GOAL NO. 2

Where pipelines and distributors are sheltered from competition and exercise considerable monopoly power, they should continue to be subject to responsible regulatory oversight.

By their very nature, interstate pipelines and local distribution companies (LDC's) can exercise monopoly or monopsony power when not restrained by competitive forces.

Many producing and consuming areas of the country are serviced by only one pipeline. Thus, a pipeline may deny or regulate producers' access to markets for their gas, and it may decide who will or will not have access to its transportation facilities.

To promote efficiency at the local level, state public utility commissions franchise LDC's as sole suppliers of service for specific consuming areas. The LDC's own and operate the distribution systems and are obligated to serve all customers in the franchise area. In return, the LDC's are granted rights-of-way for their facilities and are permitted to set rates that are intended to produce a fair return on their investment.

LDC's can (and do) refuse access to their facilities for competing gas supplies—or they charge such high rates for such access that it is tantamount to economic exclusion. In addition, some LDC's sell gas at a low price only to those customers that can use an alternative competing fuel. Exercise of this sort of market control can significantly diminish or even eliminate desirable competition in retail gas markets.

Traditionally, interstate pipelines and LDC's have been subjected to strict utility-type regulation as a substitute for competition. However, with partial deregulation at the wellhead initiated by Congress in the Natural Gas Policy Act and the recent thrust toward much more competitive natural gas markets, regulatory authorities at all levels of government should reexamine their roles in regulating pipelines and LDC's. Today, governments' principal efforts should be directed to using their regulatory powers to promote competition where competition is appropriate, but does not yet exist. In this way, regulators will best fulfill their traditional mandate of assuring consumers access to adequate supplies of gas at the lowest reasonable price.

It may appear ironic to suggest that government regulation be used to enhance competition in the marketplace; yet the thrust of the regulatory regime under the Natural Gas Act from the beginning has been to let competition flourish where possible. In today's environment, vigorous regulatory oversight will be necessary in those markets where pipelines and LDC's can continue to exercise monopoly power and thus inhibit competition. Such oversight will not only benefit consumers, but also will afford new and challenging business opportunities to all segments of the gas industry.

STRATEGIC GOAL NO. 3

There should be effective incentives for both pipelines and distributors to operate efficiently and with good business practices.

Under decades of utility-type regulation, pipelines and local distribution companies (LDC's)—and their regulators—have developed certain practices in reaction to the pressures they have faced. Understandably, since utilities' rates (and thus their profits) have been based upon the property they have devoted to utility service ("rate base"), pipeline and LDC managements have tended to seeks ways to increase the size of those rate bases. However, while this approach may be rational from a utility management's perspective, it may not make efficient use of resources as measured against the standard of a non-utility business operating in a competitive environment.

With partial deregulation of natural gas at the wellhead and the emergence of a much more competitive environment in the natural gas marketplace, pipeline and LDC managements should be encouraged to adopt attitudes and business practices suitable to the new environment. First, the way pipeline and LDC rates are set should be reexamined. Without careful regulatory consideration of whether facilities are used, useful, or prudently needed, continued use of the traditional depreciating rate base methodology encourages wasteful operations and excessive and inefficient investments, the unnecessary costs of which are passed on to end users. The purpose of utility investments should be to reduce operating costs and increase gas sales. If the investments are prudent, then profits should increase. If the investments are not prudent, then profits should not only not increase (as they do now because of inflated rate bases), but should actually decrease as they do in a competitive business environment.

Regulators at both the federal and state levels should adopt approaches toward ratemaking which place pipelines and LDC's at risk if they perform poorly, but give them rewards commensurate with such risks if they in fact operate efficiently in the new, more competitive environment. For example, regulators could adopt a range of permitted returns or profit, which would give positive incentives to pipelines and LDC's to be efficient in their operations, including the use of capital and the purchasing of gas. As measured against an appropriate standard, such as projected sales levels, firms that exceed the standard should be rewarded with higher profits, while those that fall below the standard should see their profits erode. The all-too-familiar utility strategy of applying for a rate increase to compensate for a drop in sales should be eliminated or at least severely discouraged.

Another example of how regulators could move pipelines and LDC's to operate on a more sound business basis in a competitive environment is to pe-

[redacted]

nalize them if, despite available capacity on their systems and fair compensation, they refuse to transport gas owned by other parties. Such a penalty could be in the form of a lower rate of return, removal of excess capacity from rate base, or equivalent sanction.

While this might sound like harsh medicine to some pipelines and LDC's, they will in the longer run benefit from adoption of such policies by federal and state regulators. By operating more efficiently in a more competitive environment, they will realize new opportunities to expand their business and increase their profitability. Consumers, producers, and the economy as a whole will also benefit from increased efficiency on the part of the pipelines and LDC's.

STRATEGIC GOAL NO. 4

All potential purchasers, including end users, should have equal access to all gas supplies, and pipelines and distributors should be obligated to transport on a nondiscriminatory basis all such gas for any potential shipper desiring such transportation.

In the Natural Gas Policy Act of 1978 (NGPA), Congress initiated a process leading to the partial deregulation of natural gas at the wellhead. The partial deregulation which took place on November 1, 1979 and January 1, 1985, and today's increasingly competitive marketplace have made obsolete many gas industry rules and practices taken for granted only a few short years ago. For example, while most federal domain offshore gas continues to be reserved exclusively for the interstate market (and chiefly the interstate pipelines), the original reasons for doing so have long since disappeared. The same may be said for the typical interstate pipeline practice of refusing to transport gas for third party owners if such transported gas would compete with the pipeline's own sales.

In this new, competitive environment, the old restrictions concerning who should have access to specific gas supplies simply should not survive. Gas at the wellhead is a commodity—and, as such, it should be treated like any other commodity. Thus all parties, whether pipelines, distributors, end users, marketers, etc., should be given an equal opportunity to purchase any supply regardless of location (onshore or offshore), vintage or category under the NGPA. To fully accomplish this goal, total wellhead decontrol should be achieved by a date certain.

Equal access to gas supplies will be a hollow right if prospective purchasers cannot get such gas transported at cost-based rates to where they want to use it. This means that steps must be taken by regulatory and/or legislative authorities to assure that all such parties, including end users, who desire transportation of their own gas supplies will have access to pipeline transportation and local distribution systems on a nondiscriminatory basis.

PGC believes that the twin goals of equal access to gas supplies and equal access to the nation's gas transportation system can be achieved with great benefit to all segments of the gas industry—from the wellhead to the burnertip—and to the nation as a whole. If these goals are accomplished, producers will gain access to new markets not currently using gas, plus an incentive to find new supplies. Pipelines and local distribution companies will benefit from greater throughput and thus more efficient utilization of their facilities, and consumers will be able to obtain competitively priced gas.

STRATEGIC GOAL NO. 5

Rates, including transportation rates, at both the pipeline and retail levels should be unbundled and based on the cost of providing the service.

According to general utility rate theory, rates charged by interstate natural gas pipelines and local gas distribution companies should reflect the cost of serving their individual customers or classes of customers. In practice, however, rates have reflected large subsidies by industrial users of certain other users. Unfortunately, this subsidization is more the rule than the exception. For example, a PGC survey of over 36 state gas rate cases in 14 states between 1972 and 1980 revealed that the average return (profit) sought or earned from residential users was 3.4% *while the average return from industrial users was 31.0%*, compared to an average systemwide return of 7.9%.

When the price of gas at the wellhead was relatively low (compared with prices of other fuels), this cross-subsidization went largely unchallenged. However, with the substantial increase in wellhead natural gas prices since the Arab oil embargo, it has become very important that gas rates truly reflect the cost of service. With sharply increased foreign competition and other negative cost factors adversely affecting many of our manufacturing industries, the nation can ill afford to continue to burden industry with excessive gas rates.

In today's more competitive gas marketplace, pipelines and distributors are being called upon to provide a variety of transportation services, in addition to their traditional sales services. If industrial end users and other consumers are to benefit from the competitive marketplace, transportation rates must be based on only the actual costs of the transportation service provided. This means that rates must be "unbundled," so that a transportation customer will pay only for the specific pipeline or distributor services it wants and uses. A typical pipeline's sales rate reflects the costs of the entire pipeline system, including gathering, storage, and transmission costs of various sorts. A customer desiring a simple transportation service may well not use the pipeline's gathering or storage facilities. Thus, for example, if a pipeline's "bundled" rate for regular firm sales service (excluding gas costs) were 45 cents per Mcf, its "unbundled" transportation rate (excluding gathering and storage costs) may be 30 cents per Mcf. And if the transportation service involved is interruptible, and thus of lower quality, cost-of-service ratemaking strongly suggests a rate below the 30 cent rate, for example, down to something like 15 cents per Mcf. In our example, therefore, depending on the type of service desired, a transportation customer might pay from 15 to 45 cents per Mcf depending upon the type of service actually desired and provided.

Similarly the imposition by distributors of transportation rates in the

[redacted]

range of $1 to $2 per Mcf, where the true cost range is 10 to 50 cents per Mcf, is an unwarranted abuse of monopolistic powers.

Only if rates are designed to reflect the cost of the service provided and a true cost-based menu of services is offered to transportation and sales customers of pipelines and distributors will consumers (including industrial gas users) have meaningful access to competitively priced gas. Moreover, in this more pro-competitive context, producers will have meaningful access to the available gas markets, pipelines and distributors will profit through increased and more efficient use of their existing facilities, and the entire national economy will benefit significantly.

STRATEGIC GOAL NO. 6

Curtailments of both sales and transportation services should be based on the end use of the gas.

In today's more competitive marketplace, where increasing quantities of gas are being transported for local distribution companies (LDC's) or end users, it is necessary to consider both sales and transportation services in arriving at appropriate gas curtailment policy.

It is widely recognized that curtailments of gas sales service should be based on the end use of the gas—that is, on how the gas is ultimately used at the point of consumption. The highest priorities (*i.e.*, last to be curtailed) are reserved for residential, other human needs, essential agricultural, and industrial process and feedstock uses.

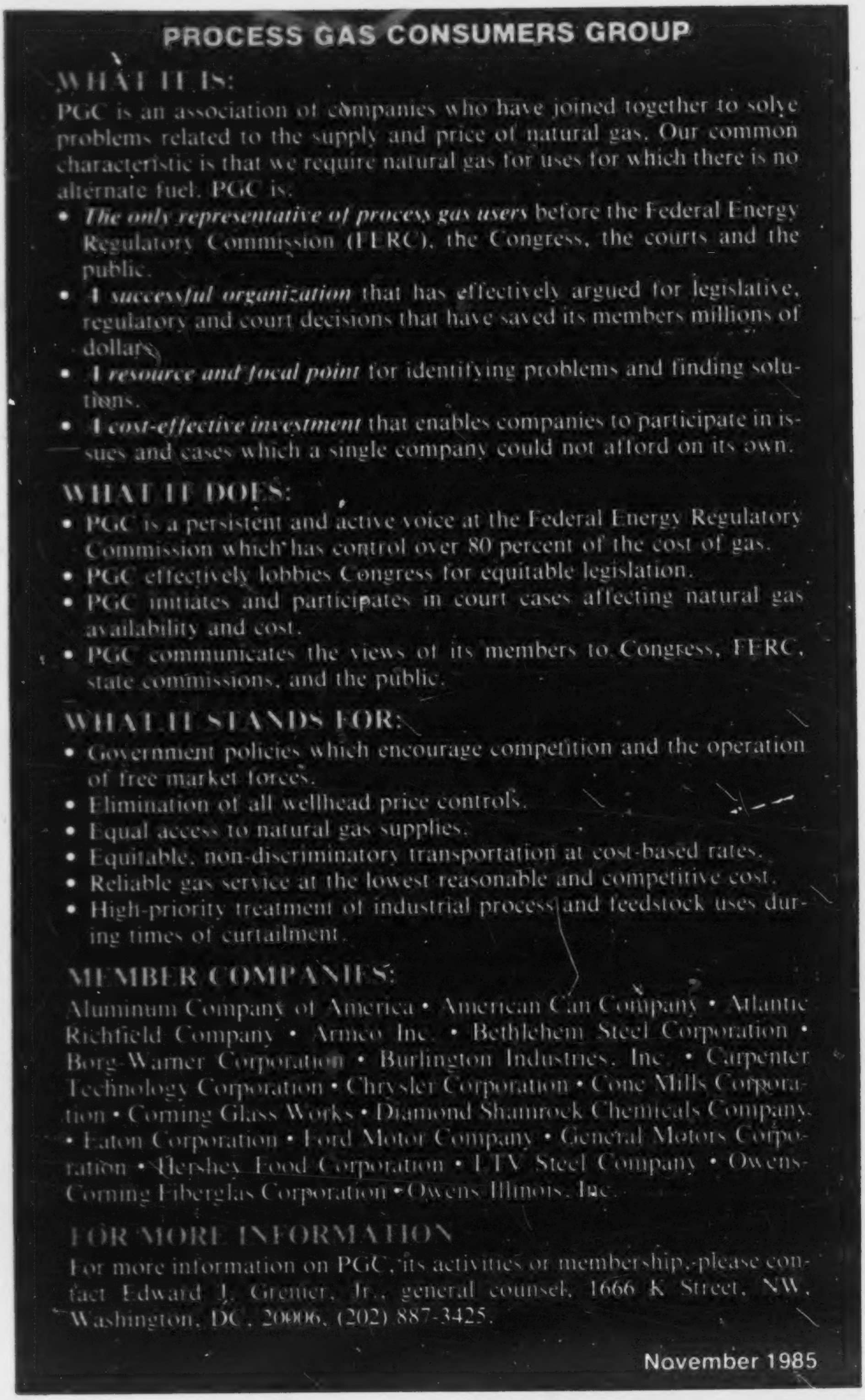
As to capacity curtailments, if a pipeline's or LDC's capacity is simply not sufficient at a particular time to handle its sales for both process uses and boiler fuel uses, normally boiler fuel uses would be curtailed. However, in a situation in which the gas delivered for a process use is not pipeline sales gas, but rather is gas owned by the end user and transported by the pipeline or LDC to the user, the question arises whether the pipeline's and LDC's sales services as a whole should receive a preference over any transportation service. PGC believes that the answer is no—sales and transportation should be treated equally where lack of pipeline capacity is the cause of the curtailment. Thus, in the above example, transported user-owned process gas should continue to be served while pipeline or LDC sales to boilers are curtailed.

If, on the other hand, a pipeline is forced to curtail because of a deficiency in its own gas supplies (*i.e.*, supply curtailments), as distinguished from lack of capacity, then curtailments should in all events be limited only to the pipeline's or LDC's sales. To include in such curtailments gas owned by a third party and only transported by the pipeline or LDC would amount to confiscation.

As to quality of service, finally, under today's conditions, curtailment priorities should take into account the firm or interruptible nature of the service. Unlike the supply-related curtailments of the 1970's, curtailments today are more likely to be related to a shortage of pipeline capacity than to a shortage of gas supplies. Under these conditions, customers served under all interruptible rate schedules or contracts should be curtailed before those served under any firm rate schedule or contract. This may mean that some pipeline or LDC interruptible sales would be curtailed before end user gas carried under a firm transportation contract. Moreover, should there be a return to supply-related curtailments, it will be necessary for regulators to take into account, in applying end-use curtailment plans, whether a customer voluntarily chose interruptible service or was forced to accept it by some earlier regulatory decision.

INFORMAL EXPLANATION OF TERMS

Commodity Charge	That portion of a rate for gas service that is based on the actual volume of gas delivered to a customer.
Commodity Minimum Bill	A requirement that the customer take a specified volume of gas or pay a "minimum bill" charge for the volumes which should have been taken, but were not.
Demand Charge	That portion of a multi-part rate for gas service that is based on the peak volume of gas the customer is *entitled* (contracted) to receive within a given time frame, regardless of whether the customer actually takes the full amount.
End Use of Gas	Refers to how the gas is used at the burnertip, for example, in a heat-treat furnace, a boiler, residential gas equipment, etc. It does not refer to end products which may be manufactured in gas-using equipment.
Feedstock Gas	Natural gas used for its chemical properties as a raw material as distinguished from use of gas as a fuel.
Firm Service	Gas service from rate schedules or contracts under which the seller is expressly obligated to deliver gas within a given time frame without interruption.
Interruptible Service	Gas service under rate schedules or contracts which anticipate and permit interruption of service on short notice.
Process Gas	Gas used in applications for which nongaseous alternate fuels are not technically or economically feasible.
Shipper	Any person or entity that arranges for the transportation of natural gas owned by someone other than the transporter.



PROCESS GAS CONSUMERS GROUP

WHAT IT IS:

PGC is an association of companies who have joined together to solve problems related to the supply and price of natural gas. Our common characteristic is that we require natural gas for uses for which there is no alternate fuel. PGC is:

- ***The only representative of process gas users*** before the Federal Energy Regulatory Commission (FERC), the Congress, the courts and the public.
- ***A successful organization*** that has effectively argued for legislative, regulatory and court decisions that have saved its members millions of dollars.
- ***A resource and focal point*** for identifying problems and finding solutions.
- ***A cost-effective investment*** that enables companies to participate in issues and cases which a single company could not afford on its own.

WHAT IT DOES:

- PGC is a persistent and active voice at the Federal Energy Regulatory Commission which has control over 80 percent of the cost of gas.
- PGC effectively lobbies Congress for equitable legislation.
- PGC initiates and participates in court cases affecting natural gas availability and cost.
- PGC communicates the views of its members to Congress, FERC, state commissions, and the public.

WHAT IT STANDS FOR:

- Government policies which encourage competition and the operation of free market forces.
- Elimination of all wellhead price controls.
- Equal access to natural gas supplies.
- Equitable, non-discriminatory transportation at cost-based rates.
- Reliable gas service at the lowest reasonable and competitive cost.
- High-priority treatment of industrial process and feedstock uses during times of curtailment.

MEMBER COMPANIES:

Aluminum Company of America • American Can Company • Atlantic Richfield Company • Armco Inc. • Bethlehem Steel Corporation • Borg-Warner Corporation • Burlington Industries, Inc. • Carpenter Technology Corporation • Chrysler Corporation • Cone Mills Corporation • Corning Glass Works • Diamond Shamrock Chemicals Company • Eaton Corporation • Ford Motor Company • General Motors Corporation • Hershey Food Corporation • LTV Steel Company • Owens-Corning Fiberglas Corporation • Owens-Illinois, Inc.

FOR MORE INFORMATION

For more information on PGC, its activities or membership, please contact Edward J. Grenier, Jr., general counsel, 1666 K Street, NW, Washington, DC, 20006, (202) 887-3425.

November 1985

Senator **Ford**. Thank you very much.
Mr. Kennedy.

STATEMENT OF JOSEPH P. KENNEDY II, PRESIDENT, CITIZENS ENERGY CORP., BOSTON, MA

Mr. **Kennedy**. Thank you very much, Mr. Ford. Rather than being the last one in, maybe I can consider it batting cleanup here.

Citizens Energy is a nonprofit corporation which was established in 1979 to help the poor and elderly in Massachusetts to meet the high cost of heating. Using the open market and normal competitive tools we were able to beat the international oil companies at their own game. We have, for seven winters now, reduced the cost of home heating oil in Massachusetts by about 40 percent.

Over 3 years ago we started to do the same thing in natural gas. At first it looked easy. Producers quickly agreed to sell us their gas at about half the price the pipelines were paying. Distributors, too, were anxious to save money and to work with us to help their poor and elderly customers. Yet, as soon as we approached the pipelines, we ran into a stone wall.

It wasn't until last year when FERC ordered some limited transportation that we were able to begin moving gas. And even with this limited transportation, we've been able to establish programs in 10 states, as well as the District of Columbia, programs which have generated over $10 million in benefits, of which $2 million have been directed to low income users.

Based on this experience, Citizens strongly supports the efforts by the FERC, and if necessary by the Congress, to open up natural gas transportation. We strongly support the Commission's decision in rule 436——

[Voting bell rings.]

Mr. **Kennedy**. I keep thinking those things are controlled by the pipelines there, Senator. [Laughter.]

We strongly support the Commission's decision in rule 436, and we are disappointed by the initial reactions of the pipelines to that rule. For years the pipelines said there was no need for legislation, that voluntary transportation would do the job. Now they have their chance, but their lawyers and lobbyists are stonewalling. If the pipelines won't volunteer, then this Congress should enact contract carriage legislation.

To promote competition, Citizens also favors block billing. Together, open transportation and block billing can save consumers $5 billion a year, or more. Block billing will promote a quicker transition to a healthy, competitive, and stable gas market. It will eliminate that subsidy that allows some producers to be paid $4 for gas that consumers are willing to pay only $2.75 for.

Block billing would give both producers and consumers the correct price signals. It would cause the producers with inefficient and high priced gas to be replaced with this cheaper gas. It is really a question of which kind of production we want to favor. These high priced contracts were entered into by the pipelines and producers without any consumers at the table. A businessman that builds a highrise office building in Houston expecting to rent space for $40 a foot isn't allowed to pass on his unrecovered costs to all renters when the building comes on the market during a glut and he can only get $30 a foot.

When pipelines attempt to hide behind their government-guaranteed monopoly in order to cover their mistakes, then this amounts to an abuse. For over 4 years now we've had a surplus at above-market prices, and frankly most of the producers have been paid out and pipelines certainly have done all right. According to the NGSA study, pipelines in 1984 made almost 25 percent on equity versus the average large industrial company. That hardly makes them a candidate for a bailout.

Sir, if our company purchases oil supplies from OPEC at unreasonable prices, we can't pass along our mistakes. The local distribution companies are still willing to pay the fixed costs of the pipelines, but consumers and local distribution companies shouldn't pay for the life of the well because some gas buyer made a mistake a few years ago.

With regard to take-or-pay, there is a solution which has not been discussed. If gas purchasing responsibilities rested in the hands of local distribution companies, then they could use their power to purchase only from producers who were willing to waive their take-or-pay obligations, and pipelines could negotiate to maximize local distribution company purchases of pipeline-supplied gas as part of the pipeline's acceptance of open transportation. This is the old carrot-and-stick approach that would make even an Abe Lincoln Republican smile.

Further, we do not believe that block billing will hurt new drilling, new drilling response to market demand, market access, and price. I know plenty of drillers ready to put holes in the ground for $2 gas, but they can't and they aren't because they can't move it. Assured transportation, not price, is the problem. With little or no access to the pipeline system, cheap gas stays in the ground or goes undrilled while the higher priced gas is forced on the consumer.

Mr. Chairman, all that's really happened here is that the price of energy around the world has fallen. The FERC has provided an opportunity to allow producers, pipelines, and gas users to split up the damages. High cost producers and pipelines have made the biggest mistakes, and that's why they're all moaning, just like the OPEC ministers who could no longer sell at $40 a barrel.

Maybe it's time for the regulators and the legislators to relax and let the competition begin.

Thank you, Mr. Chairman, and other people who might be interested.

[The prepared statement of Mr. Kennedy follows:]

JOSEPH P. KENNEDY II

TESTIMONY BEFORE THE SENATE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
(NOVEMBER 21, 1985)

MR. CHAIRMAN, SENATORS, LADIES AND GENTLEMEN:

THANK YOU MR. CHAIRMAN FOR GIVING ME THE OPPORTUNITY TO TESTIFY BEFORE YOU TODAY. I PARTICULARLY APPRECIATE YOUR INVITATION SINCE I KNOW WE DIFFER ON SOME OF THE IMPORTANT ISSUES FACING THE NATURAL GAS INDUSTRY.

CITIZENS ENERGY, A NON-PROFIT CORPORATION, WAS ESTABLISHED IN 1979 TO HELP THE POOR AND ELDERLY IN MASSACHUSETTS TO MEET THE HIGH COST OF HEATING. USING THE OPEN MARKET AND NORMAL COMPETITIVE TOOLS, WE WERE ABLE TO BEAT THE INTERNATIONAL OIL COMPANIES AT THEIR OWN GAME. WE HAVE FOR SEVEN WINTERS NOW REDUCED THE COST OF HOME HEATING OIL IN MASSACHUSETTS BY UP TO 40%.

OVER THREE YEARS AGO WE STARTED TO DO THE SAME THING IN NATURAL GAS. AT FIRST IT LOOKED EASY. PRODUCERS QUICKLY AGREED TO SELL US THEIR NEW GAS AT HALF THE PRICE THE PIPELINES WERE PAYING. DISTRIBUTORS TOO WERE ANXIOUS TO SAVE MONEY AND TO WORK WITH US TO HELP THEIR POOR AND ELDERLY CUSTOMERS. YET AS SOON AS WE APPROACHED THE PIPELINES WE RAN INTO A STONE WALL. IT WASN'T UNTIL LAST YEAR WHEN FERC ORDERED SOME LIMITED TRANSPORTATION THAT WE WERE ABLE TO BEGIN MOVING GAS. EVEN

WITH THIS LIMITED TRANSPORTATION, WE HAVE BEEN ABLE TO ESTABLISH PROGRAMS IN TEN STATES AND THE DISTRICT OF COLUMBIA -- PROGRAMS WHICH HAVE GENERATED OVER $10 MILLION IN BENEFITS OF WHICH $2 MILLION HAVE BEEN DIRECTED TO LOW-INCOME USERS.

BASED ON THIS EXPERIENCE CITIZENS STRONGLY SUPPORTS THE EFFORTS BY FERC AND IF NECESSARY BY THE CONGRESS TO OPEN UP NATURAL GAS TRANSPORTATION. WE BELIEVE THAT SUCH OPEN TRANSPORTATION IS ABSOLUTELY ESSENTIAL IF WE ARE TO ESTABLISH A COMPETITIVE MARKET FOR NATURAL GAS. SUCH A MARKET WOULD BENEFIT BOTH PRODUCERS AND CONSUMERS AND WOULD ASSURE A HEALTHY AND EFFICIENT NATURAL GAS INDUSTRY.

WE STRONGLY SUPPORT THE COMMISSION'S DECISION IN RULE 436 AND WE ARE DISAPPOINTED BY THE INITIAL REACTIONS OF THE PIPELINES TO THAT RULE. FOR YEARS PIPELINES SAID THERE WAS NO NEED FOR LEGISLATION, THAT VOLUNTARY TRANSPORTATION WOULD DO THE JOB. NOW THEY HAVE THE CHANCE BUT THEIR LAWYERS AND LOBBYISTS ARE STONEWALLING IT. IF THE PIPELINES WON'T VOLUNTEER, THEN THIS CONGRESS SHOULD ENACT CONTRACT CARRIAGE LEGISLATION.

TO PROMOTE COMPETITION CITIZENS IS ALSO STRONGLY IN FAVOR OF THE COMMISSION'S BLOCK BILLING PROPOSAL OR COMPLETE DECONTROL OF OLD GAS AS AN ESSENTIAL PRECONDITION TO A COMPETITIVE AND EFFICIENT NATURAL GAS MARKET.

OPEN TRANSPORTATION AND BLOCK BILLING TOGETHER CAN SAVE CONSUMERS $5 BILLION DOLLARS A YEAR OR MORE. WHILE WE HAVE NO PRECISE ESTIMATE WE BELIEVE THAT ROUGHLY TWO-THIRDS OF

THAT SAVINGS WILL RESULT IF PIPELINES EITHER CHOOSE TO OR ARE REQUIRED TO PROVIDE OPEN TRANSPORTATION.

YOU WILL HEAR FROM MANY WHO SAY THAT BLOCK BILLING IS THE WORST THING TO HAPPEN TO THE GAS BUSINESS. THE FACT IS BLOCK BILLING WILL PROMOTE A QUICKER TRANSITION TO A HEALTHY, COMPETITIVE AND STABLE GAS MARKET. AS LONG AS SOME PRODUCERS ARE BEING PAID OVER $4.00 FOR GAS FOR WHICH CONSUMERS ARE ONLY WILLING TO PAY $2.75, THERE IS BOUND TO BE TROUBLE. BLOCK BILLING WILL GIVE BOTH PRODUCERS AND CONSUMERS THE CORRECT PRICE SIGNALS. IT WILL CAUSE INEFFICIENT AND HIGH COST PRODUCTION TO BE REPLACED BY MORE ECONOMICAL PRODUCTION. IT IS REALLY A QUESTION OF WHICH GROUP OF PRODUCERS WE WANT TO FAVOR.

LET ME SPEAK BRIEFLY TO SOME OF THE OBJECTIONS THAT HAVE BEEN RAISED. FIRST, WE MUST RECOGNIZE THAT THE HIGH-PRICED CONTRACTS WHICH WOULD BE AFFECTED WERE ENTERED INTO BY THE PIPELINES AND PRODUCERS WITHOUT ANY SAY SO FROM CONSUMERS.

A BUSINESSMAN THAT BUILT A HIGH-RISE OFFICE BUILDING IN HOUSTON EXPECTING TO RENT THE SPACE FOR $40.00 A FOOT ISN'T ALLOWED TO PASS ON HIS UNRECOVERED COSTS TO ALL RENTERS WHEN THE BUILDING COMES ON THE MARKET DURING A GLUT. COMPLAINTS BY HIGH-PRICED PRODUCERS AND THE PIPELINES COME TO EXACTLY THE SAME THING. THEY ARE SIMPLY ATTEMPTS TO PRESERVE A PRIVILEGED POSITION AT CONSUMER EXPENSE. JUST BECAUSE PIPELINES AND PRODUCERS MADE MISTAKES IN 1979 IS NO REASON TO MAKE CONSUMERS

CARRY THE TAB FOREVER. FOR ALMOST FOUR YEARS NOW, WE'VE HAD A SURPLUS. FRANKLY, FOUR YEARS OF ABOVE MARKET PRICES IS ENOUGH.

FURTHER, WE DO NOT BELIEVE THAT BLOCK BILLING WILL HURT NEW DRILLING. NEW DRILLING RESPONDS TO MARKET DEMAND, MARKET ACCESS AND PRICE. I KNOW PLENTY OF DRILLERS READY TO PUT HOLES IN THE GROUND FOR $2.00 GAS, BUT THEY CAN'T MOVE IT. ASSURED TRANSPORTATION -- NOT PRICE -- IS THE PROBLEM. WITH LITTLE OR NO ACCESS TO THE PIPELINE SYSTEM, CHEAP GAS STAYS IN THE GROUND OR GOES UNDRILLED WHILE HIGHER PRICED GAS IS FORCED ON CONSUMERS.

BUSINESSMEN AT SOME PIPELINE COMPANIES AND SOME PRODUCTION COMPANIES ARE BEGINNING TO RECOGNIZE THAT NON-DISCRIMINATORY ACCESS IS HERE TO STAY AND ARE BEGINNING TO ADOPT THEIR PLANS ACCORDINGLY. FOR EXAMPLE, ONE PIPELINE IN ITS REHEARING COMMENTS SAID THERE WAS 'NO WAY' THEY COULD OPERATE WITHOUT TAKE OR PAY RELIEF, MODIFICATIONS OF THE CONTRACT DEMAND REDUCTIONS, ETC., ETC. THIS WEEK THEY AGREED TO ABIDE BY THE RULE AND TO NEGOTIATE WITH THEIR CUSTOMERS CONCERNING HOW TO MAKE IT WORK.

THE BUSINESSMEN WHO RUN THE PIPELINES, THE LOCAL DISTRIBUTION COMPANIES AND THE PRODUCTION COMPANIES CAN WORK OUT THE KINKS IN THIS RULE AND THE CONGRESS AND THE FERC SHOULD GIVE THEM A CHANCE TO DO SO.

COMPETITION IS THE AMERICAN WAY. IT IS HIGH TIME WE LET IT WORK IN THE GAS INDUSTRY. IF CONGRESS WANTS A HEALTHY GAS INDUSTRY, IT SHOULD STEP UP THE PRESSURE ON THE PIPELINES TO PARTICIPATE -- NOT PROTECT THEM FROM THE INEVITABLE.

WHAT WE REALLY HAVE HERE IS A CHOICE OF CONTINUED FEDERAL PROTECTION FOR PIPELINES AND HIGH-PRICED PRODUCERS VERSUS CREATING AN OPPORTUNITY FOR COMPETITION TO SHAPE A FAIR AND HEALTHY GAS INDUSTRY.

THANK YOU MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. IF YOU HAVE ANY QUESTIONS ABOUT HOW WE OPERATE OR WHAT OUR COMPANY DOES, I'LL BE HAPPY TO ANSWER THEM IF I CAN. I APPRECIATE YOUR GIVING US THE OPPORTUNITY TO PRESENT OUR COMPANY'S VIEWS.

Senator FORD. I may miss my vote, but the chairman should be back momentarily, and I'm headed the other way. I'll tell him what you all said.

[Recess.]

Senator NICKLES [presiding]. To our panelists, I apologize for the interruption, and particularly to our last two panelists, Mr. Kennedy and Mr. Bennis, for my absence during your statements.

I might just ask a couple of people if I maybe could be reviewed. A.G.A., Mr. Schroer, has some problems with the order as it is right now?

Mr. SCHROER. Yes, Senator.

Senator NICKLES. You'd be willing to do something as far as access if, what, there was either some, what, take-or-pay relief?

Mr. SCHROER. I think there has to be an incentive to the pipelines, Senator, to open access and to be able to maintain their bargaining position to continue the course of renegotiation of the contracts. I think the order is fatally deficient in not making any such provision.

Senator NICKLES. Do you think the 25 percent demand reduction is a problem, as well?

Mr. SCHROER. I get a very ambivalent reaction to that, Senator, because I have the same problem as a distributor. That is, the one thing I'm real sure of, and I have been since January 17, 1977, is that our customers don't regard our obligation to serve as any sham, smokescreen, or excuse. It's very real. To where I'm one of those fellows that's probably like Brian was talking about: I'm not sure I'm going to give Midwestern, or Natural Gas Pipe, any gas back, because we've got that $2.78 gas in our system, and I think there could be a day when that looks pretty good, and it's there for sure. To where I'm saying to you is that I share the concern that you have expressed, that Senator Bumpers has expressed, about what is abrogation of contract and what isn't, and what's regulatory and what isn't. I have a concern with that at both ends of the stream, whether you're talking about producer to transporter, or whether you're talking about transporter to distributor.

To were I—as a distributor, that favors me, of course, because it gives me a unilateral option. But I'm not real sure that's a fair option.

Senator NICKLES. I appreciate your saying that. I would say that there are some inequities there, and I have a hard time with it constitutionally, as well. I personally don't think the FERC has statutory authority to make that possible.

Would anybody care to comment on that? Yes?

Mr. LOCH. I'd like to comment on that. In the early 1970's, we thought we had very firm contract rights to fixed volumes of gas. When the gas shortage changed, the Federal Power Commission in very short order informed us that we didn't have rights to that gas. We took that all the way up to the U.S. Supreme Court and lost. All we ended up with was a very effective curtailment plan that took our entitlement away and gave it to somebody else.

Senator NICKLES. It aggrevated the problem instead of helped it?

Mr. LOCH. Yes. Then we had to start curtailment in California of our utility electric generating customers, and I don't think they've forgotten about it to this day, that they were forced to go onto high cost fuel oil at the very worst possible economic time to do so.

Senator NICKLES. What changes, if any, do any of you think the Commission might make on 436 in order to entice pipelines to participate in transportation?

Mr. WILLIAM COOPER. Chairman Nickles, I've heard what the pipelines have said, but we would hate to see the Commission just modify this rule in such a way as the pipelines want when the distribution companies also have some very real problems in which the pipelines are not quite so interested. We don't want to see the rule just tailored to bring along the pipelines and forget all about some very real problems at the distribution level.

So that's why our suggestion is that the whole order has got to be reconsidered. You can't just knock out something that the pipelines want knocked out, and bully, it's fine for them, and you cut the other people short because——

Senator NICKLES. You're afraid of bypass.

Mr. WILLIAM COOPER. We're afraid of several things. We're afraid of bypass. We're afraid of abandonments. We're afraid of capacity being watered away as the rule would do.

Senator NICKLES. Any other comments on that question of what amendments should be made on the transportation rule? Mr. Schroer?

Mr. SCHROER. Senator, I think there are four clearly indicated areas. The first—and I don't mean to be repetitive. I want to specifically answer your question.

First is, I think that there is going to have to be some leverage retained by the pipelines post-rule to where we'll continue the renegotiation process of high priced contracts. There isn't any such thing in it now. The thing we suggested to you in my prepared statement and the prepared remarks is that they either waive the take-or-pay obligations, or rengotiate the high priced nonmarket responsive provisions of existing contracts. That's one.

Two, to put 311 back in force full bore without restrictions. That's been working pretty well for 7 years, and I don't think that ought to be shut down or restricted.

The third is, if they do go to block pricing—and we're not advocating that—but if they do go to block pricing, open up that No. 2 block to where you distinguish between market responsive contracts and nonmarket responsive contracts. That block 2(a)-block 2(b) proposal.

And lastly, to get off that Disney Land Central kind of a theme on rebuttable presumption being on the part of the guy that's gotten the burden of proof. That's just a little backward from 25 years of practice that I had in the general practice. I just think that's wrong conceptually as a matter of general legal principles, and I also think it's of a highly suspect legality whether a body charged with a statutory responsibility can discharge itself of that statutory responsibility, which is about what that expedited certificate would allow.

Senator NICKLES. One comment, Mr. Schroer, just so you will know that it's there, the producers—and I'll say particularly the independent producers, and I'm going to say even more particularly the independent producers in the State of Oklahoma—would answer that the pipelines are holding the leverage, that it's very much a buyer's market, and that the prices have been rolled back especially.

I think I entered into the record earlier today where spot prices in Oklahoma right now are $1.95. This is a pretty dramatic change from a few years ago when we were looking at gas prices that were in the $5, $6, $7, $8 range. So the "leverage 'as you're saying the pipelines need to have some leverage, I think really what I hear you saying is that they want to say, yes, if we're going to take the access, if we're going to take your transportation, that we would like a corresponding somewhat reduction on the take-or-pay responsibilities for that gas.

Mr. SCHROER. I think that we're talking about two different parties, Senator. I'm not talking about leverage in terms of pricing of gas. I'm talking about leverage in terms of what responsibilities are under existing contracts, and whether you can—unfortunately, another segment of my business, I've found out to my considerable economic dismay, how difficult litigation is, let along renegotiation.

And what I'm talking about is not the independents you're talking about. I'm talking about somebody that's got a big, high-take contract and a big high price on it, and those have to be renegotiated.

Senator NICKLES. I need to go quickly, and again I appreciate your patience.

Mr. Bennis and Mr. Kennedy, did both of you make in your statements that you're supportive of Order 436?

Mr. BENNIS. Yes, sir; industry is supportive of 436.

Senator NICKLES. Do you think 436 is working right now?

Mr. BENNIS. Yes, sir; I do definitely think it's working. We can tell by the price of our gas, and we're getting clear signals now——

Senator NICKLES. Let me ask you. It's working? Is anybody moving any spot gas to you?

Mr. BENNIS. Well, in our one plant we are getting it, in one of our large plants. That's Reading, PA. Columbia is still moving it, yes, sir, at least until December 15, and hopefully thereafter.

Senator NICKLES. Maybe you're fortunate because you may be on a pipeline that may be transporting gas after December 15, but I think we've heard statements today, and I'm afraid it's going to be borne out, that by December 15 we'll find out that there will be very few, if any, maybe one or two, of the major interstate pipelines that will be participating.

Mr. BENNIS. It's a very frustrating thing in industry, and I don't know how we can afford it. As I mentioned, you weren't here, sir. One of our companies, alone, is paying $400,000 a month more because transportation did stop a few weeks ago. That's just one individual company.

Senator NICKLES. Well, doesn't that prove, though, that 436 as it is right now is not working?

Mr. BENNIS. 436 as it is written, though, we feel will work.

Senator NICKLES. If the pipelines don't participate, you're not going to get that spot.

Mr. BENNIS. Well, they're the ones, then, that should be blamed for not making it work.

Senator NICKLES. But I'm trying to just show you a picture of a present that's not working right now. I have a hard time when I hear advocates say I think it's a great deal when it's not working.

Mr. BENNIS. It's a great deal for those who are still receiving the transportation; that's correct. For the others, it is extremely damaging.

Senator NICKLES. Well, isn't it true that those who happen to be still receiving, particularly after December 15, if we don't have some changes and we don't have some acquiescence by FERC, that the majority of industrial concerns, or whoever, will not be able to benefit?

Mr. BENNIS. That's exactly right. And you'll have plants closing, as they are now.

Senator NICKLES. No doubt.

Mr. BENNIS. Already.

Senator NICKLES. And that's very much a concern of this Senator, and probably anybody that has looked at the issue.

Mr. BENNIS. And we're asking your committee to intercede in this matter and see that this doesn't happen, to use all the oversight power you possibly have to bring the pipelines on board.

Senator NICKLES. You think the only guilty culprit is the pipelines?

Mr. BENNIS. I think they're the worst culprit. I'd just like to make one little comment on the 25 percent that was made over here. I think part of FERC's reasoning for that, this is long overdue that the LDC's open up to other pipelines; that they've been the captive customer of one for so long. And this is going to open it up.

Mr. SCHROER. Senator, may I interrupt to say we've got five pipelines in a one-State company now and very richly advantaged industry.

Mr. BENNIS. And many don't. They only have one.

Senator **Nickles**. Wait a minute. I'll do this. [Laughter.]

We may have some playing back and forth, but I'll do it. [Laughter.]

Mr. Bennis, Carpenter Technology Corp. makes what?

Mr. **Bennis**. Specialty metals.

Senator **Nickles**. Do you sign long-term contracts?

Mr. **Bennis**. Sure do.

Senator **Nickles**. What would you think if Congress or somebody came up and said, well, the buyer of that could waive out of 25 percent of that?

Mr. **Bennis**. These things are negotiated in industry all the time. In a competitive business, you have to do it. And we really think it can be done. I think the producers said today they are doing it. I know for a fact they are.

Senator **Nickles**. I'm all for voluntary renegotiation. I just have a little problem when FERC or this committee or Congress tries to waive a wand and say we're going to abrogate your contract.

Mr. **Bennis**. None of us like that idea, but we think that they can be renegotiated between the parties over the short and long term, and I think it is being done. It's our understanding from talking to the producers, it is working. So, yes.

Senator **Nickles**. I agree that voluntary renegotiation is a very positive thing. But there's a big distinction when you say, yes, I like voluntary negotiation and there's a big distinction in saying, yes, I like this rule; but it has basically a fiat by a body that allows that abrogation. There's a difference between you and your buyer getting together, you as a seller and a buyer getting together and voluntarily renegotiating.

I think when you heard the renegotiations of the take-or-pays and those things, those were between two parties, sometimes with litigation and sometimes not.

I have to go quickly. Mr. Kennedy—and again, I apologize that I missed you. You did a study, or commissioned a study. You said that if this terrible Nickles amendment would pass that it would cost consumers $5 billion. Is that close to correct?

Mr. **Kennedy**. I would say that is a conservative number, Senator.

[Laughter.]

Senator **Nickles**. Well, I don't know——

Mr. **Kennedy**. Senator, with regard to some of the points that have been made earlier on the 25 percent and whether that's a good idea or not, it seems to me that first of all it's a voluntary 25 percent. It's up to the local distribution company to determine whether or not they're going to opt into the 25 percent. And the pipeline company will receive full transportation revenues whether or not they opt in—whether or not the local distribution company opts into their own purchases of natural gas or not.

So with regard to your question about whether or not the NOPR—the Order 436 is good, Order 436 as it stands today I doubt will work. However, if you went back to the original NOPR, I believe that would work.

Senator **Nickles**. Block billing included?

Mr. **Kennedy**. Block billing included. And it's not just because of block billing. But what will happen is, if you introduce the local distribution company directly into the stream so that they are able to purchase directly from the producer, then they can target what producers they are going to purchase from. And when they target what producers they're going to purchase from, they can tell that producer that they're not going to buy his gas unless they provide pipeline with the take-or-pay relief.

So what then happens is the producer says to the pipeline, you provide take-or-pay relief, then we'll buy your gas. The pipeline then says to the local distribution company: Look, fellows, we'll open up somewhat. They essentially negotiate with the local distribution company as to exactly what level everybody wants to open up in any given year, month, or day.

It seems to me that then creates an atmosphere where you get voluntary renegotiation. In addition, the FERC has indicated that where there has been voluntary renegotiation at a reasonable rate, that can be passed along to the consumer. So it seems to me that if you halfbake this thing, then you're going to go in and everybody is going to be trying to cut up their piece of the pie.

If you leave it—if you really put the bars around the picture, I think that then you'll get an atmosphere of real renegotiation. But if you only halfway do it——

Senator NICKLES. So you're all in favor of block billing?

Mr. KENNEDY. Yes, sir.

Senator NICKLES. And you want the whole——

Mr. KENNEDY. I don't believe that that's the central question here.

Senator NICKLES. Let me ask you a question. Do you favor decontrol of natural gas?

Mr. KENNEDY. You bet.

Senator NICKLES. All natural gas?

Mr. KENNEDY. All natural gas, with a windfall profits' tax on old gas.

Senator NICKLES. Oh, now you're getting——[Laughter.]

Mr. KENNEDY. I thought I'd catch your attention some way.

Senator NICKLES. You're really coming close to meddling now. [Laughter.]

You like the windfall profits' tax on the oil industry?

Mr. KENNEDY. I just wish it had lived up to what it was promised to be, sir. They promised 25 percent for the poor, and the poor have roughly gotten about 4 or 5 percent.

Senator NICKLES. Do you think the oil industry and the gas industry should be used as a vehicle to redistribute income?

Mr. KENNEDY. No, sir, I do not, but I think that when OPEC comes along and puts a gun to our head and raises the price of oil by over 1,100 percent in 7 years, that the Government has a responsibility to step in and protect the interests of the poor and the elderly and people on fixed incomes, ordinary businesses, and the ordinary consumer.

Senator NICKLES. Are you running for Congress?

Mr. KENNEDY. No, sir—[Laughter.]

Not today. [Laughter.]

Senator NICKLES. If you do, we may have some interesting debates.

[Laughter.]

Mr. **Bennis**. Senator Nickles, can I make one last comment, please?

Senator **Nickles**. Yes.

Mr. **Bennis**. The contracts between the pipelines and the LDC's have been closely regulated over the years, and their operations change from time to time. For instance, the curtailments of the 1970's. So they have been—this is nothing new. They have been regulated.

Senator **Nickles**. I want to thank all our witnesses. I have another vote, so we're going to wrap this up. I do want to—Mr. Loch, you were wanting to chime in sometime, and I didn't want to cut you off.

Mr. **Loch**. Senator, one last comment. I think one of the principal flaws of Order 436 as it stands now is that the Commission didn't come to grips with block billing. For some reasons, after ballyhooing the whole thing as a package, at the last minute they decided not to include block billing. I think settling the block billing issue—this is, FERC to deal with it, make a decision on it, and either adopt it or say that they're not going to adopt it—would be a big breakthrough in getting this order implemented.

Senator **Nickles**. Let me just throw out one final caveat or final word.

One, I personally believe block billing would be a disaster and it would perpetuate an inequity that is basically reregulation, which is the opposite of deregulation. It is regulation perpetually and would lock in inequities in the marketplace and distort the marketplace for a long time, and wouldn't allow the marketplace as such to operate.

We will wrestle with that issue before the FERC. I agree that having it hanging out there causes a lot of chaos in itself, and there's a lot of things going on in the market.

I do wish to ask all of our panelists—there are several questions that I have. Mr. Schroer, one final question. Does A.G.A. have anything as far as the amount of curtailments? Have you done anything amongst your pipeline members to know the amount of shutin gas that's been shut in as of November 1?

Mr. **Schroer**. We believe it to be about 3 trillion cubic feet a year, and about 2.5 in 1986.

Senator **Nickles**. I appreciate that very much. If you have, or if there's been an analysis, pipeline-by-pipeline and you could give that to the committee as far as the amount of curtailments that have been made as a direct result of this order effective November 1, that would be very helpful for us when we're trying to digest this.

As you can easily tell, when you're talking about all the various pipelines and groups, it's difficult to see what the total effect is nationwide, and that might help fulfill it.

We will submit additional questions, and again I thank you very much for your appearance today.

The hearing is adjourned.

[Whereupon, at 2:27 p.m., the subcommittee recessed, to reconvene Wednesday, November 27, 1985, in Tulsa, OK.]

REVIEW OF THE FEDERAL ENERGY REGULATORY COMMISSION'S ORDER NO. 436

WEDNESDAY, NOVEMBER 27, 1985

U.S. SENATE,
SUBCOMMITTEE ON ENERGY
REGULATION AND CONSERVATION,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Tulsa, OK.

The subcommittee met, pursuant to notice, at 9 a.m., in Tulsa, OK, Hon. Don Nickles presiding.

Present: Senator Nickles.

Also present: Howard Useem, professional staff member.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Good morning. This is the second of 2 days of oversight hearings on the Federal Energy Regulatory Commission's order No. 436. The first day was held on November 21 in Washington, DC, before my Energy Regulation Subcommittee.

As I am sure everyone is aware, order 436 created a voluntary natural gas transportation program that has enlisted few volunteers. Of the 128 interstate pipelines that file tariffs with the Commission, only 11 have agreed to participate, many of which are relatively small pipelines. Only 4 of the 20 largest interstate pipelines are now participating, and it is not clear how many of these will continue to participate beyond December 14, the last day of the 45-day transition period.

Although order No. 436 was intended to get pipelines to voluntarily provide transportation services to move natural gas from producers to consumers, it has instead had the opposite effect. I am very concerned about the lack of pipeline participation after the 45-day transition period, which ends on December 14.

Pipelines are now transporting less gas than before the new program went into effect and, as a result, producers are being forced to shut in gas production that otherwise could be marketed. I know of many producers located in Oklahoma and elsewhere who now have gas wells shut in because pipelines are not transporting gas for them. I expect to get a better feeling today on the extent of this problem.

I also hope to find out exactly why pipelines are unwilling to participate in the Commission's program. This will enable the committee to assess the reasons for the lack of participation and determine what legislative steps, if any, need to be taken.

In my opinion, the FERC has gone way beyond reasonable action with its latest rulemaking. Obviously, the necessary incentives to make its rules work fell far short of reality. Not only has the FERC hurt producers, but also they have hurt consumers. I personally hold the Commission responsible for whatever economic ruin and displacement is caused by the regulatory bungling.

It is essential that pipelines make transportation services available on a nondiscriminatory basis so that residential, commercial, and industrial gas consumers can be assured access to supplies of natural gas.

A viable transportation program also helps producers find a market for gas that otherwise would be shut in; it encourages competition in the natural gas market; and it helps hold down the price of gas to consumers. In short, a workable transportation program is in everyone's interest.

That is why on November 7, I introduced Senate Resolution 255, along with Senators Domenici, Dole, Boren, and Gramm. The lack of pipeline participation is a clear indication that the Federal Energy Regulatory Commission needs to make significant changes to its program in order to get pipelines to participate.

In my opinion, unless and until more pipelines agree to participate, we will have on our hands a growing crisis in the natural gas transportation industry.

Today's hearing is also about the Commission's so-called "block billing" proposal. Although order No. 436 did not adopt the block billing proposal contained in the NOPR, it was modified and the Commission requested further comments on it.

I am absolutely and totally opposed to the Commission's block billing proposal. In my opinion, block billing would be the worst of all possible worlds. It would take away incentives to explore for new and develop existing supplies of natural gas that are needed to replace existing reserves that are being depleted through consumption.

Block billing would provide no incentives to increase production from old gas reservoirs. Thus, it would increase our dependence on insecure supplies of foreign energy.

Moreover, block billing would not level the playing field, as is claimed by the Commission. It would just tilt the playing field in a different way, creating new winners and many losers. It would greatly distort and disrupt an already chaotic gas market, and would cause massive abrogation of contracts.

I strongly believe that the FERC does not have the statutory authority to implement block billing.

At the committee's November 21 hearing on the Commission's NOPR there was nearly unanimous agreement that block billing is a bad idea and would not and could not work.

I plan to testify before the FERC on December 11, the public conference on the block billing proposal, to express my views directly to the Commissioners.

We have several witnesses today who are experts in the field and who are well aware of the effect of order No. 436.

I also note there are other individuals that indicated to me that they would like to make statements at the conclusion of the hearing and we will try to accommodate those requests as well.

Our first two witnesses today are the Honorable Hamp Baker, commissioner of the Oklahoma Corporation Commission, who is accompanied by Ms. Gail Stricklin, assistant general counsel of the Oklahoma Corporation Commission. I am pleased that we have both joining us.

Commissioner Baker, we welcome you, and, Ms. Stricklin, we welcome you to the committee, and we look forward to hearing your comments.

Mr. **Baker**. Senator Nickles, and ladies and gentlemen, we have some formal comments that Ms. Stricklin is going to read this morning and after she concludes those, I would like to make some informal statements.

Senator **Nickles**. OK, that will be fine.

Ms. Stricklin.

STATEMENT OF GAIL STRICKLIN, ASSISTANT GENERAL COUNSEL, OKLAHOMA CORPORATION COMMISSION

Ms. **Stricklin**. Chairman Nickles, ladies and gentlemen, the Oklahoma Corporation Commission appreciates the opportunity to testify today.

The commission is a constitutionally created administrative agency. It regulates, among other things, the production of natural gas.

Its duties are the protection of property rights, known as correlative rights, and the prevention of waste, which includes the unreasonable production or nonproduction of natural gas.

The Federal Energy Regulatory Commission, also known as FERC, has exclusive jurisdiction over the transportation of natural gas by interstate pipelines. However, the Oklahoma Corporation Commission is concerned with the new and proposed rules as they affect Oklahoma production.

The Oklahoma Corporation Commission has been involved with the proposed regulations of the FERC since they were noticed last year. It has submitted written comments which are attached to our prepared statement and it has given oral testimony concerning the regulations which may significantly impact the natural gas production industry in Oklahoma.

Keep in mind that in 1984 Oklahoma was the third largest producer of natural gas in the Nation.

There are two parts of the Federal regulations which concern the commission.

First, the failure of interstate natural gas pipelines to provide nondiscriminatory transportation service has resulted in the shutting in of approximately 3 million cubic feet a day of natural gas.

As you know, order No. 436 permitted interstate pipelines to voluntarily provide open access transportation services. The failure to provide that service has resulted in not only the shutting in of gas wells, but less producer revenues, lower severance taxes for the State treasury, and fuel switching by customers who can no longer directly purchase natural gas.

These customers are switching to oil and may be lost forever. The Oklahoma Corporation Commission is concerned with the potential loss of these markets and others.

The commission understands the initial reluctance of interstate pipelines to embrace the significant changes envisioned by the transportation regulations of order 436. Pipelines historically have acted as middlemen, purchasing or producing gas for resale.

The control which the pipelines have historically asserted over natural gas as a commodity is definitely weakened by order 436. Pipelines will be relegated under order 436 to the business of being transporters of gas where they should be able to continue earning revenues constituting a reasonable rate of return.

However, the ultimate failure of interstate pipelines to participate in a free market economy, opting not to provide transportation services, but retaining exclusive control of the commodity of natural gas is indefensible.

The Oklahoma Corporation Commission commends Senate Resolution 255, introduced by you, Mr. Chairman, and supports incentives which will encourage the nondiscriminatory transportation of gas.

The second concern that the Oklahoma Corporation Commission has is the proposed regulation known as block billing. The commission plans to testify in opposition to the adoption of this rule in December before the FERC.

Most commentators agree that block billing will cause wellhead prices to decrease. Lower wellhead prices in Oklahoma means lower State revenues.

Estimates of reduced severance tax revenues of $31.6 million a year have been reported to the commission.

Lower wellhead prices also mean lower producer revenues. The Natural Gas Supply Association has estimated that producers will lose $3 billion to $6 billion in revenues as a result of block billing. Lower revenues mean less exploration and development of future reserves.

The Natural Gas Supply Association has estimated a decrease in gas drilling from 25 to 55 percent if block billing is enacted.

A final and unintended consequence of block billing is to encourage the use of alternative fuels. End users will switch to another source of fuel if only high cost gas is available and new users will choose an alternative energy source.

It is, therefore, obvious that future markets for natural gas may be discouraged by block billing and, more importantly, future supplies of deliverable natural gas will be in jeopardy.

Another concern which Oklahoma has regarding block billing is the continued viability of its conservation laws. While the FERC explicitly stated that the proposed rule would not affect the State's authority to regulate production, the commission is aware that some pipelines do not appreciate State conservation laws and, as a general rule, refuse to comply with State statutes.

These interstate pipelines prefer to be regulated by the FERC and have recently claimed in an Oklahoma City Federal court that the FERC has exclusive jurisdiction over interstate pipelines, regardless of the State's constitutionally recognized interest in preserving its natural resources.

We, therefore, urge that explicit language emphasizing the State's power over production be included if block billing is ultimately accepted by the FERC.

The Oklahoma Corporation Commission is also prepared to enact regulations which will prevent abuses to correlative rights of Oklahoma property interests by interstate pipelines. The State and Federal regulations must coexist and complement each other.

Some pipelines' reluctance to cooperate with the State must change as the production of natural gas is closely tied to an interstate pipeline's business. Any proposed legislation should reflect these concerns, as we all must cooperate to ensure a viable natural gas industry.

Thank you.

Senator **Nickles**. Thank you very much.

Mr. Baker.

STATEMENT OF HAMP BAKER, COMMISSIONER, OKLAHOMA CORPORATION COMMISSION

Mr. **Baker**. Mr. Chairman, I had the opportunity last week to participate in a national conference with commissioners from all over America. It is known as NARUC.

I think we have just begun to penetrate the eastern seaboard understanding what block billing really means. When we first began to talk about block billing, I believe the eastern customers understood that they were going to receive a benefit.

However, after realizing that the historical customer in the growth areas would receive the second block billing in growth, new factories such as would be implemented, that it would be detrimental to their growth, because when you have one industry at one price and another, the next-door neighbor, at block 1 prices, it would make it discriminatory.

I told them that I thought it would be a lawyer's paradise trying to get through all of what would happen. The Maryland council, if they thought they won something there, they would certainly under block billing have plenty to go for.

I just want to make all of you people here who have connections in Washington and who work with the Washington lobbyists, I think if you will start immediately to work on the people who represent these different States, consuming States, and to tell them and explain to them how detrimental it will be to new growth and new businesses, and that the rolling in of the price of block 1 will not help their customers and it will not be of benefit.

Once that gas is used up, all they are going to get is gas at a higher price. Naturally, when it is gone, you will just see a price that will continually grow to them.

They may be getting an average now of $4. It will be $5 and $6, because the roll-in price that we have been able to have here in this State and other producing States for their benefit to keep the price down will be gone.

No. 2, and Gail mentioned this in her reading, virtually in the field it is going to be impossible to produce this type of gas. However, there are pockets of block 1 gas that can be produced, such as the Huguenot field in Kansas and in Oklahoma in the Panhandle areas. There is some of this gas.

But where we have had tremendous in-field drilling across this State, where we have one well that would be in block 1, and three wells in the same section would be under block 2, the commission under our jurisdiction condition, and the constitutional duties that we have, absolutely cannot let that gas be produced under just saying we are going to let all the cheap gas go first.

Every producer in this room should be screaming their heads off and coming to the commission saying, "Do not let that happen." They would be saying that and we are not going to let it happen. I expressed this to the commissioners individually, but I think it fell on deaf ears.

I think they had their minds made up when they started. However, we have two new commissioners now I think we could probably prevail upon, hopefully; but at the present time I just see a chance that we might accidentally win this block billing, if we work hard enough, because I saw what happened last week.

In our executive committee, New York, Florida, North Carolina, and several of the States had seen what it would do and they voted with us to present a resolution for NARUC to present to FERC. I am extremely proud that we were able to prevail on those people on that one thing.

I think as we present our testimony and our thoughts to these people, we can win if we will work hard enough.

[The prepared statement of Mr. Baker follows:]

STATEMENT OF OKLAHOMA CORPORATION COMMISSION BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

CHAIRMAN NICKLES, LADIES & GENTLEMEN:

My name is Hamp Baker and I am a Commissioner of the Oklahoma Corporation Commission.

The Oklahoma Corporation Commission is deeply concerned with the turmoil in the natural gas industry today. The regulation of interstate natural gas pipelines as envisioned by Order No. 436 encourages the development of a competitive market which should help the Oklahoma gas industry. However, the failure of pipelines to provide nondiscriminatory transportation access to Oklahoma producers and the implementation of "block billing" threaten the goal of competition. Thank you, Senator Nickles for providing the Oklahoma Corporation Commission this opportunity to comment on the Federal Energy Regulatory Commission regulations.

Additional comments of the Oklahoma Corporation Commission will be presented by Gail Stricklin, staff attorney with the Commission.

The Commission is a constitutionally created administrative agency. It regulates, among other things, the production of natural gas. Its duties are the protection of property rights known as correlative rights and the prevention of waste which includes unreasonable production or nonproduction of natural gas. The Federal Energy Regulatory

Commission ("FERC") has exclusive jurisdiction over the transportation of natural gas by interstate pipelines. However, the Oklahoma Corporation Commission is concerned with the new and proposed rules as they affect Oklahoma production.

The Oklahoma Corporation Commission has been involved with the proposed regulations of the FERC since it was noticed last year. It has submitted written comments which are attached hereto and has given oral testimony concerning the regulations which may significantly impact the natural gas production industry in Oklahoma. In 1984, Oklahoma was the third largest producer of natural gas in the nation and the eighth largest consumer in 1983.

There are two parts of the federal regulations which concern the Commission. First, the failure of interstate natural gas pipelines to provide non-discriminatory transportation service has resulted in the shutting in of approximately three hundred million cubic feet a day. As you know, Order No. 436 issued October 9, 1985 permitted interstate pipelines to voluntarily provide open access transportation services. The failure to provide that service has resulted in the shutting-in of gas wells, less producer revenues, lower severance taxes for the state treasury and fuel switching by customers who can no longer directly purchase natural gas. These customers are switching to oil and may be lost forever. The Oklahoma Corporation Commission is concerned with the potential loss of these future markets and others.

The Oklahoma Corporation Commission understands the initial reluctance of interstate pipelines to embrace the significant changes envisioned by the transportation regulations of Order No. 436. Pipelines historically have acted as middlemen - purchasing or producing gas for resale. The control which the pipelines have historically asserted over natural gas as a commodity is definitely weakened by Order No. 436. Pipelines are relegated under Order No. 436 to the business of being transporters of gas where they should be able to continue earning revenues constituting a reasonable rate of return.

However, the ultimate failure of interstate pipelines to participate in a free market economy, opting not to provide transportation services but retaining exclusive control of the commodity of natural gas is indefensible. The Oklahoma Corporation Commission commends Senate Resolution No. 255, introduced by Chairman Nickles and supports incentives which will encourage the non-discriminatory transportation of natural gas.

The second concern that the Oklahoma Corporation Commission has is with the proposed regulation known as "block billing." The Oklahoma Corporation Commission plans to testify in opposition to the adoption of this rule in December before the FERC. "Block billing" establishes two commodity blocks and encourages the movement of "old, low cost gas" (known as Block I gas) to historical customers. All other gas including higher cost gas would be included in Block II.

Most commentators agree that block billing will cause wellhead prices to decrease. Lower wellhead prices in Oklahoma means lower state revenues. Estimates of reduced severance tax revenues of $31.6 million/year have been reported to the Commission. Lower wellhead prices means lower producer revenues. The Natural Gas Supply Association has estimated the loss of $3-6 billion dollars nationwide next year in lost producer revenues. Lower revenues means less exploration and development of future reserves. The drilling of new gas wells is not economically feasible to a large segment of the industry. This situation will be compounded should prices decline further. The Natural Gas Supply Association has estimated a decrease in gas well drilling from 25%-55% if block billing is enacted.

A final and unintended consequence of "block billing" is to encourage the use of alternative fuels - end users will switch to another source of fuel if only high cost gas is available and new end-users will chose an alternative energy source.

It is therefore obvious that future markets for natural gas will be discouraged by "block billing" and, more importantly, future supplies of deliverable natural gas will be in jeopardy as a result of "block billing". The economic model upon which the FERC relies for this proposal has been criticized as ignoring the basic economics surrounding the incentives to explore for and develop new reserves. If producers do not have sufficient capital to reinvest in exploration and development, a shortage of natural gas will result in the future - similar to the shortages of the late 1970's which can be attributed to federal regulation. The gas bubble is expected to disappear as early as 1988. The short term goal of providing low cost gas for selective customers does not promote a national policy of assuring an adequate supply of natural gas for the future.

Another concern which Oklahoma has regarding "block billing" is the continued viability of its conservation laws. While the FERC explicitly stated that the proposed rule would not effect the state's authority to regulate production, the Commission is aware that some pipelines do not appreciate state conservation laws and, as a general rule, refuse to comply with state statutes. The interstate pipelines prefer to be regulated by the FERC and have recently claimed in an Oklahoma City federal court that the FERC has exclusive jurisdiction over interstate pipelines regardless of the State's constitutionally recognized interest in preserving its natural resources. We therefore urge that explicit language preserving the state's power over production be included if "block billing" is ultimately accepted by the

FERC. The Oklahoma Corporation Commission is also prepared to enact regulations which will prevent abuses to correlative rights of Oklahoma property interests by interstate pipelines. The state and federal regulations must coexist and compliment each other. The pipelines' reluctance to cooperate with the State must change as the production of natural gas is closely tied to an interstate pipeline's business. Any proposed legislation should reflect these concerns as we all must cooperate to insure a viable natural gas industry.

The Oklahoma Corporation Commission appreciates the opportunity to testify today and will answer any questions at this time.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas) Pipelines After Partial) Wellhead Decontrol)	Docket No. RM85-1-000 (Part D)

COMMENTS OF THE OKLAHOMA CORPORATION COMMISSION

The Oklahoma Corporation Commission hereby submits the following comments in response to the Federal Energy Regulatory Commission's Notice Requesting Supplemental Comments, issued October 1, 1985, relating to "block billing."

I.

COMMUNICATIONS

All correspondence and communications relating to these proceedings should be directed to the following:

Lindil C. Fowler, Jr.
General Counsel
Office of General Counsel
Oklahoma Corporation Commission
460 Jim Thorpe Building
Oklahoma City, Oklahoma 73105

II.

THE IMPACT THAT THE PROPOSED RULE MAY HAVE ON NATURAL GAS SUPPLIES AND MARKETS SHOULD BE SERIOUSLY CONSIDERED

The Oklahoma Corporation Commission notes that the Federal Energy Regulatory Commission has addressed the concern which the Oklahoma Corporation Commission expressed in its comments filed in response to the Notice of Proposed Rulemaking issued May 30, 1985. In particular, the assurance that the state's authority over natural gas production and conservation including the prorationing of production and ratable takes will not be disturbed by the proposed block billing is applauded. However, the Oklahoma Corporation Commission believes the Federal Energy Regulatory Commission should be cognizant of potential adverse effects of "block billing". It is a reasonable as well as necessary goal for this nation to attempt to assure itself of adequate reserves of gas for the future and the development of new and stable markets for such reserves.

However, presently, natural gas supplies are being depleted at a rate faster than new supplies are being discovered. This conclusion is confirmed by Oklahoma's active drilling rig count. Last year at this time (November 3-8), there were 331 drilling rigs exploring for gas in

Oklahoma. For the same period in 1985, there are only 258 drilling rigs in action. Exploration activity may continue to decline if the effect of "block billing" is to drive down the price of an already declining wellhead price. Less money to the producer for its commodity means less investment in the future of natural gas. It is estimated that the imposition of "block billing" will result in decreased revenues to producers in billions of dollars. This decline in producer revenue would have the effect of further reducing exploration and development of natural gas reserves, thus jeopardizing an adequate supply of natural gas for the future. While there is a short term projection of lower consumer prices, the long term repercussions to the customers and the nation in light of a questionable readily available future supply of gas at unquestionable higher costs should be carefully considered.

In addition, the proposed rule may have the unintended effect of discouraging the development of future markets by limiting the availability of certain categories of gas to historical customers. Natural gas as an energy source may not attract potential new markets -- commercial, industrial or residential -- if the rolled-in pricing concept is abandoned. Alternative sources of energy may be more economical than the "block 2" gas available. Developing future markets for natural gas is an important consideration in regulatory policy so as to assure the continued viability of the natural gas industry.

The Oklahoma Corporation Commission urges the Federal Energy Regulatory Commission to assure that there is not only a demand for natural gas in the future, but a marketable supply.

Respectfully submitted,

Lindil C. Fowler, Jr.
General Counsel
Office of General Counsel
Oklahoma Corporation Commission
460 Jim Thorpe Building
Oklahoma City, Oklahoma 73105

November 15, 1985

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

REGULATION OF NATURAL GAS)
PIPELINES AFTER PARTIAL)
WELLHEAD DECONTROL.)

DOCKET NO. RM85-1-000
(Parts A-D)

EXECUTIVE SUMMARY OF COMMENTS OF THE OKLAHOMA CORPORATION COMMISSION

I. The attempt to impose common carrier obligation on intrastate pipelines is in conflict with the federal regulatory scheme established by the Natural Gas Policy Act of 1978.

II. The purported assertion of jurisdiction over intrastate pipelines pursuant to the proposed §311 regulation interferes with the Oklahoma Corporation Commission's regulatory authority over public utilities.

III. Abrogation of take-or-pay obligations should be carefully considered.

IV. Section 154.38 may be inconsistent with state conservation and production laws.

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

REGULATION OF NATURAL GAS PIPELINES AFTER PARTIAL WELLHEAD DECONTROL.	)))	DOCKET NO. RM85-1-000 (Parts A-D)

COMMENTS OF THE OKLAHOMA CORPORATION COMMISSION

The Oklahoma Corporation Commission hereby submits the following comments in response to the Federal Energy Regulatory Commission's Notice of Proposed Rulemaking ("NOPR") issued May 30, 1985.

The Oklahoma Corporation Commission is a constitutionally created body whose responsibilities include the prevention of waste and the protection of correlative rights through the regulation of production of oil and gas and by requiring ratable takes of gas by pipelines as well as exercising supervisory jurisdiction over all phases of public utility regulation, including the establishment of end user rates and terms and conditions of service. The Oklahoma Corporation Commission is concerned that the proposed Section 311 transportation regulation by the Federal Energy Regulatory Commission ("FERC") will significantly interfere with and impede this state's regulatory scheme imposed on intrastate pipelines, usurping the state's power over this area.

I.

THE ATTEMPT TO IMPOSE COMMON CARRIER OBLIGATIONS ON INTRASTATE PIPELINES IS IN CONFLICT WITH THE FEDERAL REGULATORY SCHEME ESTABLISHED BY THE NATURAL GAS POLICY ACT OF 1978 ("NGPA").

There is no statutory basis for the terms and conditions set forth in Section 284.124 of the NOPR. Section 602(b)(2) of the NGPA, 15 U.S.C. §602(b)(2), provides that "[n]o person shall be subject to regulation as a common carrier under any provision of Federal or State law by reason of any transportation . . . authorized by the commission under Section 311(a) of this Act." The attempt to condition a statutorily permitted service under Section 311(a)(2) upon terms implicit in common carrier status is questionable at the very least. Any final rule which attempts to impose common carrier status on intrastate pipelines absent express statutory authorization is impermissible.

II.

THE PURPORTED ASSERTION OF JURISDICTION OVER INTRASTATE PIPELINES PURSUANT TO THE PROPOSED §311 REGULATIONS INTERFERES WITH THE OKLAHOMA CORPORATION COMMISSION'S REGULATORY AUTHORITY OVER PUBLIC UTILITIES.

"[R]egulation of utilities has been recognized as one of the most important functions traditionally associated with the police power of the States." Arkansas Electric Cooperative Corp. v. Arkansas Public Commission, 461 U.S. 375, 76 L.Ed. 2d. 1, 6 (1983), citing Munn v. Illinois, 94 U.S. 113, 24 L.Ed. 77 (1877). Regulatory jurisdiction over utilities, including intrastate pipelines that are also local distribution companies, is designed to establish and maintain reliable service at the lowest reasonable cost to the consumer while maintaining the financial integrity of the utility. An integral part of that regulation by the Oklahoma Corporation Commission involves reviewing and approving the terms and conditions of service which have historically included the authorization to transport gas for others and requiring a percentage of profits earned from such transportation to be used to reduce charges to consumers. Similarly, profits earned from off-system sales are applied as a credit to offset the cost of gas through the fuel adjustment clause. Part 284 of the NOPR threatens the continued vitality and stability of the state regulatory scheme.

First, if a state jurisdictional company elects not to transport on behalf of others, that company's customers are denied the benefits of sharing in the profits through a purchased gas adjustment credit, which complements the rate structure established by the Oklahoma Corporation Commission. For example, the Oklahoma Corporation Commission in Cause No. 28069, Order No. 247376, has ordered that when Oklahoma Natural Gas Company ("ONG"), an intrastate pipeline/local distribution company ("LDC"), transports gas under §311(a), 75% of all revenues from such transportation is credited to all classes of consumers through its fuel adjustment clause. If ONG chooses not to transport gas under § 311(a) under the proposed rules, the revenues currently used as credits are no longer available to offset the cost of fuel to ONG's LDC customers. Obviously, the effect is higher charges to ONG's customers.

Second, if an intrastate pipeline/LDC elects to utilize the provisions of § 311(a), the continued assurance of adequate service to the end users may be jeopardized under the proposed rules. Under the Oklahoma Corporation Commission's reading of the NOPR, if an intrastate pipeline/LDC elected to transport under § 311(a), it would be required to transport for all who requested such service. The situation could very easily arise where the LDC would have to curtail or prorate supplies of gas to its distribution customers in order to meet the needs of shippers requesting transportation. This situation works not only to the detriment of the affected LDC customers, but potentially to end use customers of the shipper requesting transportation. End use customers such as municipalities serving residential customers, hospitals, nursing homes and other state-established high priority customers would be subject to curtailment or prorationing of gas supplies as the capacity of the intrastate pipeline/LDC is reached or exceeded.

Imposition of the proposed rules on intrastate pipeline/LDC's raises the question of which set of curtailment rules would apply. The Oklahoma Corporation Commission establishes curtailment schedules for each intrastate pipeline/LDC which it regulates. To the extent that one or more elect to transport under § 311(a) and curtailment becomes necessary, the NOPR does not address whether the curtailment schedule set out in the FERC rules and regulations would apply or whether the curtailment schedules established by the Oklahoma Corporation Commission would apply. To the extent that there are any conflicts between the two, the intrastate pipeline/LDC could be forced into the position of violating either federal or state curtailment rules. This situation cannot be justified. Oklahoma ratepayers may well not receive adequate service due to federal interference in Oklahoma's affairs.

The proposed requirement of "transportation service for all shippers" would theoretically permit a single end use customer of the intrastate pipeline/LDC to contract for the transportation of gas directly from the wellhead thereby bypassing the LDC. This situation could very well result in a "death spiral" scenario to the LDC as there would be fewer customers and fewer units of gas over which to spread the LDC's fixed costs resulting in higher rates to the remaining customers. Whether the existing regulatory framework as relating to intrastate pipeline/LDCs has provided distorted economic incentives for end users to bypass their local ultities is a matter that should be explored on a state specific basis. Concerns regarding such local issues should be left to state regulatory bodies.

Third, movement of gas is a concern which the Oklahoma Corporation Commission is empowered by state statutes to address. For example, every person engaged in the transportation of natural gas is declared to be a common carrier and obliged to provide nondiscriminatory service. See, 52 O.S. §24.

Therefore, intrastate pipelines should be excluded from this rulemaking.

III.

ABROGATION OF TAKE-OR-PAY OBLIGATIONS SHOULD BE CAREFULLY CONSIDERED.

The Oklahoma Corporation Commission is concerned with the abrogation of contractual rights and take-or-pay obligations by the pipelines which is proposed in Part 161 of the NOPR. Careful consideration must be given to the potential impact of such abrogation on producing states' economies, such as Oklahoma's, as well as the possibility of curtailment of exploration and development which would directly impact national defense. Such proposed abrogation must be considered in light of companies who are already unable to service their debt. Such companies and, in some cases, their respective financial institutions, stand on the brink of collapse. Voluntary renegotiation of contracts should be encouraged unhindered by federal regulatory intervention.

IV.

SECTION 154.38 MAY BE INCONSISTENT WITH STATE CONSERVATION AND PRODUCTION LAWS.

Section 154.38 establishes a three-part billing procedure which eliminates the rolled-in pricing of "old" gas with "new" gas. This policy fosters firm transportation of "old" gas. In practice, Oklahoma's prorationing and ratable take statutes and regulations may be adversely affected by the NOPR when a pipeline's customer demands a supply of "old" gas and the state requires the taking of gas pursuant to a priority schedule which gas may not be classified as "old." See Exhibit A attached hereto. For example, Oklahoma Corporation Commission Rule 1-305 provides that when the supply of gas exceeds the demand therefor, a pipeline must take gas from first, hardship and distressed wells; second, enhanced recovery wells; third, wells producing casinghead gas and associated gas; and fourth, all other. The State may have difficulty in regulating its production in light of the federal policy favoring the movement of old gas.

CONCLUSION

The Oklahoma Corporation Commission appreciates the opportunity to express its views on the proposed rules and would encourage the FERC to seriously review these areas of concern in light of its proposed interference with traditional state regulatory functions of intrastate pipelines and production of natural gas.

Respectfully submitted,

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July 12, 1985

EXHIBIT A

RULE 1-305. PRIORITY SCHEDULE FOR SUPPLY AND DEMAND IMBALANCE.

(a) Any common purchaser as defined in 52 O.S. 1981, Section 240, shall purchase all the gas which may be offered for sale, and which may reasonably be reached by its trunk lines or gathering lines, without discrimination in favor of one producer as against another or in favor of any one source of supply as against another, except as authorized by the Commission under (b) below.

(b) In the interest of the prevention of waste and protection of correlative rights, the following priority schedule shall be implemented by any first purchaser of gas whenever the permitted production from all wells in any common source of supply in its system in this state, including gas which is processed, is in excess of that purchaser's reasonable market demand; provided, however, if the first purchaser does not contractually control wellhead production, then the first taker of gas shall be responsible for implementation of the following priority schedule.

(i) Priority One - Hardship and distressed wells.

(ii) Priority Two - Enhanced recovery wells.

(iii) Priority Three - Wells producing casinghead gas and associated gas.

(iv) Priority Four - If after the first purchaser or first taker has taken the gas from Priorities One through Three above and still has further market demand in its system for gas, said purchaser or taker shall take ratably from all allocated, special allocated and unallocated common sources of supply which may be offered for sale, and which may reasonably be reached by its trunk lines or gathering lines, without discrimination in favor of one producer as against another or in favor of any one source of supply as against another.

(c) When permitted production of gas from all wells from which a purchaser or taker is required to take exceeds the market demand of said purchaser or taker, all reductions in gas purchases or takes from wells in each Priority shall be ratable. All production from the lower priority wells shall be shut-in before production from any well in the next higher priority is curtailed.

(d) Any well which meets the definition of more than one priority shall be assigned the higher priority.

(e) When there is more than one purchaser or taker involved in the taking of gas from a well into any purchaser's system, all purchasers and takers within that system shall be responsible for compliance with this Rule.

(f) Upon a verified application of the Director of the Oil and Gas Conservation Division, or any other person, the Commission, after notice and hearing, may determine if gas has been ratably purchased or taken from a common source of supply on a systemwide basis in accordance with this rule without avoidable waste and with equitable participation in production and markets by all operators and other interested parties.

(g) In any month wherein a purchaser or taker has a market demand/supply imbalance and must curtail purchases or takes in compliance with this Rule, Form 1004 B shall be filed by said purchaser or taker with the Oil and Gas Conservation Division.

(h) Any interested party may file an application requesting that the Commission, for good caure shown, authorize limited deviation from the general priority schedule provided under (b) above. The Commission on its own motion may initiate a review of the continued need for such a limited deviation. After notice and hearing, the Commission may authorize limited deviation upon finding that the same is necessary in order to prevent waste, protect correlative rights, or is otherwise required by the public interest or authorized by law.

Senator **Nickles**. Thank you for your comments and I appreciate your efforts in working against the block billing proposal.

I will add the caveat that if we win, it will not be because of luck. It will be because we have had a lot of efforts that are going into it.

Just for your information, I really do appreciate your talking to some of your counterparts in some of the other States. That is important.

On the block billing proposal, I do not want to be too optimistic, but I do think that the plan through the hearings became so evidently flawed that that amount of fact and presentations before not only our committee, but also before the FERC, that they should modify it.

They did agree to postpone it, so we consider that was a victory of some sort to give time for consideration of that proposal.

The statements are in almost unanimous opposition from pipelines and producers and from many consumers saying that they did not think it would work. We do have two new Commissioners and, hopefully, that will help when the Commission takes it back up.

More in the consequences of that, which I think, Ms. Stricklin, you mentioned a couple of figures. You are talking about block billing and what that might do.

You also mentioned the transportation. I was not sure which was which. You mentioned one had a loss to the State of what, 300 million cubic feet a day?

Ms. **Stricklin**. Yes, that is transportation.

Senator **Nickles**. It is strictly on transportation?

Ms. **Stricklin**. Figures that we have gotten.

Senator **Nickles**. Since November 1?

Ms. **Stricklin**. Yes.

Senator **Nickles**. The State of Oklahoma is not shipping out 300 million cubic feet per day——

Ms. **Stricklin**. That is approximate.

Senator **Nickles** [continuing]. That we were moving out on the spot market?

Ms. **Stricklin**. That is correct.

Senator **Nickles**. That the pipelines are no longer participating, so we have that amount of gas shut in. In dollars and cents, that is what, $600,000 a day?

Ms. **Stricklin**. Multiply it by—that could be, yes, $2 an MCF.

Senator **Nickles**. A $600,000 per day loss to producers, and then 7 percent of that would be what is lost to the State of Oklahoma. So we are talking about big dollars for the producers and we are talking about big dollars for the State of Oklahoma because of FERC's ruling concerning transportation.

Ms. **Stricklin**. Or the failure of the interstate pipelines to elect to provide the transportation.

Senator **Nickles**. In my statement I primarily directed my wrath at the FERC, because part A of the FERC order did say that if pipelines participate after December 15, that they would have to allow their end-use customers to reduce or abrogate their contracts by 25 percent per year.

I personally find that very objectionable and think that if that is one of the primary reasons for a pipeline not participating that they have a legitimate complaint. I have a long-held belief that the FERC or Congress should not be causing massive contract abrogation.

Would you agree with that? Do you find the 25 percent part of the transportation rule objectionable as well?

Mr. BAKER. To me, you know, you have two schools of thought on this. Of course, the pipeline companies, and there are several here in this room, who are interested in getting out of their take-or-pay and they see if, on the other hand, they are not allowed to back off on the producers at the same rate, they are going to be held on their take-or-pay.

This is, you know, I can see it from the producer's side, some of them say, "I do not want to let the pipeline out of my contract." Others say, "Let me out and I can sell my gas and move it, get it moved, maybe on a more not seasonal basis. I can move it all year round. If I could have an industry that is operating all year round, I could sell the gas."

However, we find that most of this gas is sold at a cheaper price than the pipelines are paying. Each producer has to make his own individual judgment himself, how he wants to sell his gas and how he wants to market it, if the markets are opened up.

Senator, I do want you to remember that El Paso, which is one of the largest buyers of gas going to California, from November 1 until one day—I do not remember exactly——

Senator NICKLES. December 14.

Mr. BAKER. Somewhere along there. They were backed off 300 million feet a day, so at one time we had over 600 million a day not moving in Oklahoma. We do not actually know what El Paso is going to do after December 15.

So, at that time we may be backed off to even more gas in Oklahoma if this is approved, or they may choose not to take their blanket certificate. It would be very detrimental because they are not only moving gas out of the Anadarko Basin, they are moving it from all over Oklahoma, through the Mustang contract that they have.

So, to me, the people in California are the recipient of a vast resource of Oklahoma technology, money, supplies, and they are making money off of Oklahoma every day, because they are the recipient of rolled-in prices.

If we go to the block billing, they are going to get the cheaper gas for a while and they are going to cry, "Give me Canadian gas," because it will be cheaper when we go to the second block.

I just think it is going to be very detrimental to America as a whole if this is implemented and I just think that it is one of the things that is dreamed up by an economist who—and I am not going to say which one, but, in my opinion——

Senator NICKLES. I know which one you are talking about. [Laughter.]

Mr. BAKER. I do not want to make him too mad already, but he actually believes it will work, Senator, and you can just preach all day to them that it will not work, it physically will not work. It is detrimental to all classes of Americans.

After all, we as a producing State, about 70 percent of our gas is moved out of Oklahoma through the interstate system to customers who do not know anything about producing gas in Oklahoma and they think we have been holding it back here in Oklahoma just to keep the price up.

We have to work very hard on our image that "Dallas" and "Dynasty" and all the radio shows and TV shows that show us, but really what we are, we are just hard-working people trying to produce gas and make a living.

Those people have to be educated to the point that we are trying to do something for them and for their benefit and make them understand that block billing will not work. This is our goal and we are going to do everything we can to help you achieve it.

I just want to really commend you for what you have done. If it had not been for you and your efforts, I think we would have block billing today.

Senator **Nickles**. I appreciate your comments, and we will continue working together with you on it. I will mention that FERC, if you read their stated objectives, I would not disagree with a lot of their stated objectives.

They are saying, "We would like more gas to be moving in the marketplace at market rate," et cetera, free enterprise. But then if you look at block billing, block billing is not a step toward free enterprise.

Block billing is a step toward reregulation of gas prices perpetually and it does not move into a deregulated market. It moves into a reregulated market that would cause greater distortions than even what we have today.

So, again, I want to thank you very much for your appearance before the committee and your comments, and I look forward to your statements.

I would like to get a copy of your statement as well as I will give you a copy of mine before the FERC. Maybe we will be successful in convincing them or just illustrating to them that, quite frankly, although well intentioned, their rule is not having the intended effect.

Pipelines are not participating and we are not moving gas, so their stated objectives to have much, much greater volumes going in with greater access, better deals for everyone, and, quite frankly, with the lack of participation, it just has not worked. We need to show them those facts.

Mr. **Baker**. My opinion, and this is mine, too, if they could not deregulate the old gas, they will just use it all up and get rid of it and then would not have to contend with it any more. To me it is just detrimental. We need the old gas to roll it in to keep the prices down and really make it producible in the field.

Senator **Nickles**. Thank you very much.

Mr. **Baker**. Thank you.

Senator **Nickles**. Ms. Stricklin, thank you.

On our next panel we have Mr. Ted Davis, manager of natural gas operations from Conoco. We also have Mr. Jack Graves, president of Calumet Oil Co., and also president of Oklahoma Independent Petroleum Association, who is accompanied by David House, who is vice president for administration of Samson Resources, and also is chairman of the natural gas committee for the Oklahoma Independent Producers.

We also have Bryan Whitworth, vice president of government relations for Phillips Petroleum; and Vinod Dar, who is president of Hadson Gas Systems.

To all our panelists, I appreciate your participation. Many of you have been with us before on this issue or other issues. I think you contribute substantially to not only the hearings, but also to the education of myself and others and I am most grateful for that.

Mr. Davis.

STATEMENT OF TED E. DAVIS, GENERAL MANAGER, NATURAL GAS DEPARTMENT, CONOCO, INC.

Mr. DAVIS. Senator Nickles, I am Ted Davis, general manager of the natural gas department of Conoco. My department is responsible for the sale of Conoco's natural gas production, as well as the procurement of gas supplies for Du Pont, our parent company.

In 1984 Concoco produced 250 billion cubic feet of natural gas, while Du Pont and Conoco together consumed 150 billion cubic feet at 69 industrial facilities located in 26 States.

Senator, I would like to thank you for the opportunity to testify today. Conoco has a significant interest in the State of Oklahoma and strongly believes that those interests are the same as the citizens of this State.

We want to acknowledge the leadership that you have displayed in dealing with the energy issues facing Oklahoma and the Nation.

Conoco believes this Nation needs a free and unencumbered natural gas market for the benefit of consumers, distributors, pipelines, and producers alike. We see two factors as being essential for the achievement of this objective: Open and nondiscriminatory access to transportation. And, two, the total decontrol of natural gas.

Senator NICKLES. Can everybody hear? We do not have a real good microphone system.

Go ahead.

Mr. DAVIS. The Commission's order 436 has rightfully addressed the voluntary transportation issue. As a major consumer of U.S. natural gas, Du Pont considers nondiscriminatory transportation essential. Thus far, most pipeline companies have not yet chosen to be voluntary transporters, and whether they change their minds in the future remains to be seen.

To date, however, most pipelines are not transporting natural gas. While complete industry data is unavailable, most pipelines have reported decreased transportation.

Conoco as a producer and Du Pont as a consumer have been significantly impacted by order 436. Roughly 10 percent of our production which had been moving or was scheduled to move has now been shut in due to pipelines' failure to adopt the voluntary transportation program proposed by FERC, or to allow us to continue the transportation arrangements we had in place.

Likewise, Du Pont has lost transportation for approximately 40 percent of its total demand from interstate pipeline carriers.

Something that has not been mentioned too much, I imagine Conoco, like a number of other producers, have a number of gas wells which have been completed and are ready for hookup, which cannot now be hooked up or transported. Pipelines are full and are not willing to buy additional reserves at this time. They were ready to transport before order 436 and now we cannot even get them transported.

If pipelines ultimately fail to provide nondiscriminatory transportation, Conoco and Du Pont would support mandatory carriage as a part of comprehensive natural gas legislation.

I would like also, for the record, to discuss take or pay a minute. Considerable confusion seems to exist as to what take-or-pay clauses actually are.

Take or pay essentially provides that if a pipeline fails to take from the producer a predetermined percentage of the deliverability of a well, then the pipeline pays the producer the dollar value of the gas not taken.

Take-or-pay clauses in contracts normally have two provisions which need to be understood: One, a makeup or recoupment provision. And, second, a refund provision.

Speaking to the recoupment part, in later periods when a pipeline has taken more gas than the contract minimum, the additional gas is not paid for again, but is deducted from earlier take-or-pay payments.

Considering the refunds, when a set time period expires, normally 5 years in the contract, the seller returns the nonrecouped take-or-pay payments to the pipeline company.

Additionally, if the well happened to deplete before the 5 years is up, then the money is also returned. Therefore, essentially, take or pay is an interest-free loan with the producer getting to keep all the interest earned on the money while he has it.

Finally, I think even more important, we have to understand that even before 436 that take-or-pay problems were being worked out in the industry by means of negotiation between producers and pipelines. Conoco has settled over 80 percent of our understanding take-or-pay claims. So, I do not feel that this is quite the problem that it is made out to be.

Natural gas prices must be free to reflect the true market conditions in the future. The FERC's block billing proposal will not accomplish this. Even the existing regulatory system we have, flawed as it is, is preferable to the Commission's proposal. Block billing would be detrimental to the U.S. economy and the long-range supply security of this Nation.

The low wellhead prices resulting from block billing would not give producers adequate cash flow to continue to explore for and to develop U.S. reserves.

If implemented, significant revenue losses to producers would further reduce natural gas drilling, which in turn would lead to a severe decline in proven U.S. gas reserves and deliverability.

My numbers are a little different from the ones you heard earlier and I think it depends on how low you think the gas price will go. But Conoco estimates that in Oklahoma producer revenue could fall as much as $1 to $1.3 billion range next year.

Such a revenue loss would not only adversely affect the producers, but the hundreds of service firms and their employees in Oklahoma. If you multiply it times the factor for the severance tax, it could come up to as much as $90 million annually for Oklahoma.

We need also to speak shortly about reserves here. When the current deliverability surplus disappears, speeded by reduced gas well drilling, imported energy would have to be used as a stopgap to fulfill domestic demand. By the year 2000, the proven reserves we have on the books today will provide only 20 percent of the estimated demand in the year 2000.

One thing we also need to remember is there is a serious timelag in the natural gas industry. It takes 3 to 5 years to bring an onshore gas field from discovery to full production and from 7 to 15 years for an offshore field.

The United States does not have the luxury to allow this hiatus in our natural gas exploration and development drilling.

Considering the old gas question that has been brought up earlier, this Nation's proven supplies of old natural gas should be fully recovered. In January of this year the DOE estimated in a report to President Reagan that 38 trillion cubic feet of old natural gas reserves will not be recovered under today's low regulated prices.

The reserves are there. The wells are already drilled. The pipelines are connected. But artificially low price ceilings limit the economic life of these reserves.

When cash flows from a well can no longer pay the well's operating expenses, it is plugged and abandoned. Without adequate price incentives, necessary work to fully recover these reserves simply cannot be justified.

We cannot afford to allow more than 2 full years of U.S. natural gas supply, which this 38 trillion cubic feet is, to be prematurely abandoned. The needs of this Nation for a secure, long-term natural gas supply are typified by Du Pont's own situation.

Without competitively priced gas, continued operation of 69 Du Pont plants in 26 States is threatened, as are the jobs of the thousands of employees who work in these plants.

In summary, open and nondiscriminatory transportation is essential to our industry and the only way to provide U.S. consumers with a reliable supply at the lowest reasonable cost is to allow natural gas prices determined by the marketplace, which will justify the risks and expenditures incurred in exploring for and developing natural gas.

Again, Senator, thank you for your leadership in this effort. We are all behind you 100 percent.

[The prepared statement of Mr. Davis follows:]

TESTIMONY OF TED E. DAVIS
GENERAL MANAGER, NATURAL GAS DEPARTMENT
CONOCO, INC.
BEFORE SENATOR DON NICKLES
TULSA, OKLAHOMA
NOVEMBER 27, 1985

Senator Nickles, I am Ted Davis, General Manager of the Natural Gas Department of Conoco. My department is responsible for the sale of Conoco's natural gas production, as well as the procurement of gas supplies for Du Pont, our parent company.

In 1984, Conoco produced 250 BCF of natural gas while Du Pont and Conoco together consumed 150 BCF at 69 industrial facilities located in 26 states.

Senator, I would like to thank you for the opportunity to testify today. Conoco has a significant interest in the state of Oklahoma and strongly believes that those interests are the same as the citizens of this state. We want to acknowledge the leadership that you personally have displayed in dealing with the energy issues facing Oklahoma and the nation. We are convinced that without your leadership and participation, very inappropriate decisions would have been implemented by the Federal Energy Regulatory Commission this last year.

Conoco believes this nation needs a free and unencumbered natural gas market for the benefit of consumers, distributors, pipelines and producers alike. We see two factors as being essential to the achievement of this objective:

(1) Open and non-discriminatory access to transportation, and
(2) The total decontrol of natural gas.

The Commission's Order 436 has addressed the voluntary transportation issue. As a major consumer of U.S. natural gas, Conoco's parent, Du Pont, considers non-discriminatory transportation essential. Thus far, most pipeline companies have not yet chosen to be voluntary transporters, and whether they change their minds in the future remains to be seen.

With the issuance of Order 436, the transportation of natural gas is in chaos. Most pipelines are not transporting. While complete industry data is unavailable, some pipelines have reported decreased transportation. For instance, Natural Gas Pipeline Company of America, which transports gas into Illinois and Michigan, is today transporting 400,000 MCF less than before November 1st. Much of that gas came from Oklahoma. Conoco as a producer and Du Pont as a consumer have been significantly impacted by Order 436. Roughly 62,000 MCFD of gas which had been moving or was scheduled to commence movement has now been shut-in due to pipelines' failure to adopt the voluntary transportation program proposed by FERC. Likewise, Du Pont has lost transportation for 24,000 MCF a day or 37% of its total pipeline demand outside of Texas.

Again, due to the pipelines' failure to adopt open transportation. In our mind,...should pipelines fail to provide non-discriminatory transportation, Conoco and Du Pont would support mandatory carriage as a part of comprehensive natural gas legislation. At the testimony on November 13th and 14th before the House Subcommittee on Fossil and Synthetic Fuels, chaired by Representative Sharp, the pipeline witnesses repeatedly alleged that participation in the Open Access Transportation Program would result in take-or-pay exposure of hundreds of millions of dollars.

For the record, I would like to discuss take-or-pay. Take-or-pay provisions are essential in gas sales agreements. Producers rely on those provisions to insure that cash inflow occurs in return for committing reserves to a purchaser. Financing of future drilling, either from internally generated funds or loans from third parties is dependent upon assurances of sales or take-or-pay payments.

Considerable confusion seems to exist as to exactly what a take-or-pay provision is. Most simply put, a take-or-pay provision provides that if a purchaser fails to take from the seller a minimum percentage of the deliverability from a well, then the buyer pays to the seller the dollar value of the gas not taken. In a subsequent period, after the buyer has taken the contract minimum, additional gas taken is not paid for but the earlier payment is credited against the cost of that gas. Additionally, should the reserves be depleted before the buyer receives full credit for his take-or-pay payments or if a certain time period expires, typically 5 years, then the seller returns to the buyer his take-or-pay payments. Recognizing that pipelines receive these payments from future production or by the seller returning the payments, puts an entirely new light on the pipelines' claims of disaster. Finally, it is important to understand that take-or-pay obligations or the purported "high price contract problem" is being resolved. Conoco has negotiated and settled over 80% of the claims between it and its purchasers. Those settlements have included terms which include market responsive pricing language. Producers and pipelines negotiated contracts in the past and it is incumbent upon these parties to renegotiate these contracts as required by the market. Pipelines have no basis for refusing to participate in Open Access Transportation simply because they will be required to "work diligently" to resolve contract questions with producers.

Natural gas prices must be free to reflect true market conditions. The FERC's block billing proposal will not accomplish this. Even the existing regulatory system, flawed as it is, is preferable to the Commission's proposal. Block billing would be detrimental to the U.S. economy and the long range supply security of the nation.

The low wellhead prices resulting from block billing would not give producers adequate cash flow required to continue to explore for, and develop, U.S. natural gas reserves. If implemented, drastic revenue losses to producers would further reduce natural gas drilling, which in turn would lead to a severe decline of proven U.S. gas reserves and deliverability.

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Conoco estimates that the annual impact of block billing would range from 3-5 billion dollars. For Oklahoma, producer revenue could fall by as much as $1.3 billion. Such a revenue loss would adversely impact not only producers but the hundreds of service firms and their employees in Oklahoma. The state would suffer a severance tax revenue decrease of as much as $90 million annually. The disaster to Oklahoma brought on by block billing would be replayed across the nation with natural gas shortages and curtailments. When the current short term deliverability surplus disappears, speeded by reduced gas well drilling, imported energy would have to be used as a "stop gap" to fulfill domestic demand. By the year 2000, the proven reserves we have on our books today will provide only 20% of the estimated demand. This is serious when you stop to think that the year 2000 is just 15 years away...and that it takes 3 to 5 years to bring an onshore gas field from discovery to full production...and from 7 to 15 years for an offshore field.

The U.S. does not have the luxury to allow a major hiatus in our natural gas exploration and development drilling. This nation's proven supplies of old natural gas should be fully recovered. In January of this year, the DOE estimated that 38 TCF of these "old" natural gas reserves will not be recovered under today's low regulated prices...the reserves are there; the wells are already drilled; the pipelines are connected; but...artificially low price ceilings limit the economic life of these reserves. When cash flows from a well can no longer pay the well's operating expenses...it is plugged and abandoned. Without adequate price incentives, necessary work to fully recover these reserves simply cannot be justified.

It would be a travesty to allow more than two full years of U.S. natural gas supply to be prematurely abandoned, never to be recovered!

The needs of this nation for secure, long-term natural gas supply are typified by Du Pont's own situation. Without competitively priced gas, continued operation of 69 Du Pont plants in 26 states is threatened...as are the jobs of the thousands of employees who work in those plants.

In summary, no one wants to return to the shortages and curtailments of the 1970's...the only way to provide U.S. consumers with reliable supply, at the lowest reasonable cost, is to allow natural gas prices determined by the marketplace, which will justify the risks and expenditures incurred in exploring for and developing reserves. Then all gas reserves, old and new, would be developed in a rational and orderly manner justified by true market economics.

Senator NICKLES. Thank you, Mr. Davis. We appreciate your comments.

Mr. Graves.

STATEMENT OF J.M. GRAVES, PRESIDENT, CALUMET OIL CO., AND PRESIDENT, OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

Mr. GRAVES. Thank you, Senator Nickles, and good morning.

The 1,500 members of the Oklahoma Independent Petroleum Association welcome and appreciate this opportunity to express their views on the effect of FERC order 436 and the very damaging effect it will have on Oklahoma's natural gas industry.

Also, on behalf of our members, we wish to convey our appreciation for your commitment to make sure, Senator, that our industry is not ravaged by bureaucratic fiat.

Given Oklahoma's current economy, any further erosion of the State's natural gas industry, especially erosion that is brought about by Government action instead of uninhibited market action, would have serious consequences.

It is too late to entirely avoid the harm of 436, for we have already been hurt, but it is your effort which has given us some hope that the harm can be mitigated.

Senator, you are well aware of the immediate results of the new transportation rules issued in 436. In Oklahoma, hundreds of wells are being shut in; millions of cubic feet of natural gas are not flowing; and tens and hundreds of independent producers are feeling increased financial pressure.

The exact amount of gas shut in by independents is very difficult to come by. No one likes to brag about it because of the fragile relationship that already exists between the independents and their banks. They certainly do not want to go down and tell their banker that they are on the brink of financial disaster.

For a time they were barely making ends meet through spot-market sales and special marketing programs. Now that those are gone, many independents are trying to stay one step ahead of bankruptcy court.

Those who might weather the overwhelming rejection of the new transportation rules by interstate pipelines probably will not survive the block billing portion of 436 when it goes into effect in 1986.

If the potential harm from 436 becomes a reality, then independent producers, the State of Oklahoma, indeed, the entire Nation will be forced to deal with radically decreased exploration for new natural gas reserves, which unavoidably will lead to decreased supplies of natural gas.

We all know that the independents have been drilling some 80 to 90 percent of the wells that have been drilled in the lower 48 the last few years.

It is frustrating to try to understand how the Commission fails to see the potential short-term and long-term effects of their proposals. It is further baffling to understand why the Commission seems bent on reliving the natural gas shortages of the mid- and late-1970's.

They apparently have forgotten how schools and factories had to be closed in wintertime because of the unavailability of adequate natural gas supplies. Logic dictates that decreased exploration and dwindling reserves will bring about a repeat of that time.

As you know, Senator, OIPA feels that the new transportation rules have not come close to the Commission's expectations or promises. Despite warnings from producers, pipelines, and consumers, the Commission proceeded with its plan. Only a handful of interstate pipelines have agreed to provide transportation. The majority have refused.

Because so many pipelines refused to carry gas, we became concerned about possible antitrust implications. That is why OIPA earlier this month asked Attorney General Meese to investigate if there are any antitrust implications to this process.

While we are concerned about the immediate impact of decreased transportation, we are also worried about next year when the independent natural gas producers, who have spent billions of dollars searching for new gas reserves, must take a back seat, while cheaper and less costly ways to find old gas is given preferential treatment.

We were encouraged to go out and find the new gas 6 years ago and that we did. Now we are being punished for doing just that.

OIPA is seriously concerned about the welfare of the natural gas industry as a result of the order. All signs point to disaster if something is not done soon.

Again, we thank you for all you have done and anything else you can do to preserve the industry. Only a handful of interstate pipelines have agreed to provide the transportation. The majority have refused, as you know.

Years ago the Chinese called us the "Paper Tiger." I hate to say it, but I am afraid that that statement may come true in the United States. I would advise you and assure you that FERC 436 dovetails right in with the present tax reform program in trying to push the country toward a total reliance on a paper economy.

It will not be very satisfying and gratifying in years to come to know that perhaps we lead the world in poodle grooming, but that we do not have a real hard economy of goods, raw materials, and manufacturings that any viable economy needs.

FERC tell us that imported gas will make us more efficient in finding and producing domestic gas. Our first reaction to that is if FERC would get off our backs, we would immediately become more efficient in what we are about to do because we would have more time in which to do it.

Senator, if we had to endure FERC while selling crude oil, I can assure you the country would be at least 60 percent dependent on imported oil.

I commend our gas producers for being able to operate under FERC, but I am afraid that 436 will cause the decline of our domestic energy.

Thank you very much, sir.

[The prepared statement of Mr. Graves follows:]

Comments of:

Jack Graves, President
Oklahoma Independent Petroleum Association

Before:

The Honorable Don Nickles, United States Senate
Senate Energy and Natural Resources Committee
Subcommittee on Energy Regulation and Conservation

Wednesday, November 27, 1985
Tulsa, Oklahoma

Thank you Senator Nickles and good morning. I am Jack Graves, President of OIPA, the Oklahoma Independent Petroleum Association. The 1,500 members of OIPA appreciate the opportunity to express their views on the Federal Energy Regulatory Commission's Order No. 436 and its affect on Oklahoma's natural gas industry.

Also in behalf of our members, we wish to convey our appreciation for your commitment to make sure our industry is not ravaged by bureaucratic fiat. Given Oklahoma's current economy, any further erosion of the State's natural gas industry, especially erosion that is brought about by government action instead of uninhibited market action, will have serious consequences. It is too late to entirely avoid the harm of Order No. 436, for we already have been hurt. But, it is your efforts which give us some hope the harm can be mitigated.

Senator, you are well aware of the immediate results of the new transportation rules issued in Order No. 436. In Oklahoma, hundreds of wells are being shut in, millions of cubic feet of natural gas are not flowing, and tens and hundreds of independent producers are feeling increased financial pressure. Many are on the brink of financial ruin. For a time, they were barely making ends meet through spot market sales and special marketing programs. Now that those are gone, many independent producers are trying to stay one step ahead of bankruptcy court.

Those who might weather the overwhelming rejection of the new transportation rules by interstate pipelines, probably will not survive the Block Billing portion of Order No. 436 when it goes into effect in 1986.

If the potential harm from Order No. 436 becomes reality, then indepdendent producers, the State of Oklahoma, indeed, the entire nation will be forced to deal with radically decreased exploration for new natural gas reserves, which, unavoidably, will lead to decreased supplies of natural gas. It is frustrating to try to understand how the Commission fails to see the potential short-term and long-term harm. It is further baffling to understand why the Commission seems bent on reliving the natural gas shortages of the mid and late 1970s.

The Commission apparently has forgotten how schools and factories had to be closed in wintertime because of the unavailability of adequate natural gas supplies. Logic dictates that decreased exploration and dwindling reserves will bring about a repeat of that tragic time.

As you know, OIPA feels the new transportation rules have not come close to the Commission's expectations or promises. Despite warnings from producers, pipelines and consumers, the Commission proceeded with its plan.

Only a handful of interstate pipelines have agreed to provide transportation. The majority have refused. Because so many pipelines refused to carry gas, we became concerned and asked Attorney General Edwin Meese to investigate possible anti-trust implications.

Years ago, the Chinese called us a "paper tiger". I assure you that the Commission's Order No. 436 dovetails with the present tax reform proposals in shoving the country toward reliance on a total paper economy-- one that is not based on manufacturing and raw materials, but on services.

The Commission tells us that imported gas will make us more efficient in finding and producing natural gas. My first reaction to that is if the Commission would get off our backs, we immediately would be considerably more efficient.

Senator, if we had to endure the Commission while selling crude oil, the country would become at least 60 percent dependent on imports.

I commend our gas producers for being able to operate under the Commission, but I am afraid that Order No. 436 will cause the decline of our domestic industry.

While we are concerned about the immediate impact of decreased transportation, we also are worried about next year when independent natural gas producers, who spent billions of dollars searching for new gas reserves, must take a backseat, while cheaper and less-costly-to-find old gas is given preferential treatment. Six years ago, we were encouraged to go out and find the new gas, now we are being punished for doing just that.

OIPA is seriously concerned about the welfare of the natural gas industry as a result of Order No. 436. All signs point to disaster if something is not done soon, and, again, we thank you for all you have done and anything else you can do to preserve the industry.

Thank you.

Senator NICKLES. Mr. Graves, thank you very much.

Also, we have with you, representing the Oklahoma Independent Petroleum Association, David House, who is vice president for administration of Samson Resources.

Mr. House.

STATEMENT OF DAVID W. HOUSE, VICE PRESIDENT FOR ADMINISTRATION, SAMSON RESOURCES CO., AND CHAIRMAN, NATURAL GAS COMMITTEE, OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

Mr. HOUSE. Thank you, Senator Nickles, for the opportunity to speak today.

I think that your record is complete with the facts and figures and problems that order 436 brought about. I concur with your analysis that the rapidity with which pipelines were forced to make those decisions to accept open access and the 25-percent annual CD reduction causes them significant problems.

Rather than restate the problem, I would like to—for parts A, B, and C of the order 436, I would like to suggest two solutions that maybe you could recommend to the Commission and they would consider in their rehearing.

It is almost impossible for anyone to take 35 years of business decisions and turn them around in a 45-day period. The pipelines have understandably made certain decisions that they made based on a rate case that they would not have made if they had known they were going to be simply a transporter of gas.

I think that an analogy might be that a consumer now tells us where to drill and all we become is contract drillers. I do not think we would be too happy with that decision.

I think that if the Commission would consider an extension of time for implementation so that the pipelines could relook at their business and in the interim time provide producers of Oklahoma some method of moving gas, that might ease the pipelines' feelings toward order 436.

The other large concern is that pipelines are being forced to lose their contracts with their customers and yet they claim that take or pay will be a problem.

My suggestion in this area is that pipelines make a calculation of their total take-or-pay that has been overlooked or forgiven by many producers so that you come to a percentage of take or pay liability versus take or pay actually made.

As long as that percentage is greater than 25 percent, they should have no complaint about losing 25 percent of their customers, because they have not made take-or-pay payments equal to that amount.

I do not know if I have made myself clear, but if the problem is take or pay, then maybe we could see that they do not have that problem and maybe it is only an illusion that is out there and not an actual problem.

Those are my comments in regard to the transportation portion.

I would like to quickly make four comments on block billing. The Commission in its notice of inquiry set out four criteria for just and economic rates. I would like to state that I do not believe that block billing meets any of those four criteria.

The first criteria was that a just and economic rate is an efficient price that relates current cost to current values. In other words, gas sells for at least its replacement cost.

I do not think that gas today on the marginal sales is equal to his replacement costs and I think that block billing would drive that down further and, therefore, it would not meet that criteria.

Their second criteria is a rate that provides fair competition between pipelines or a pipeline in competing fuel. The current marginal rate today is below that. We are experiencing gas-on-gas competition, not gas-on-oil competition, but gas on gas.

Senator NICKLES. Could you give us a little illumination of that? If gas is selling for $2 on the spot market, what would that be in, say, No. 6?

Mr. HOUSE. I think the No. 2 fuel oil conversion rate is—or accrual rate is about 6 to 1 and I think the No. 6 oil rate is about 4 to 1, I believe. I am probably guessing.

I could amplify that for you in written comments later, but I think that what I am trying to say is that the FERC set out that a fair rate would be one in which gas competes with the No. 6 oil. We are way below that now. We have got gas competing with gas; No. 6 oil left the market a long time ago for people that could switch.

Senator NICKLES. No. 6 oil may be selling for what, $28.50, or something like that?

Mr. HOUSE. Something like that, yes, sir.

Senator NICKLES. And the equivalent of $2 gas would probably be around $12?

Mr. HOUSE. So, $12 or $13, right.

Senator NICKLES. So No. 6 is about twice as high?

Mr. HOUSE. Right.

The third criteria is that the rate would not lead to wasteful depletion of scarce, nonrenewable resources. I think that block billing would in many instances encourage people who have total access to block billing gas not to be as careful in conserving the gas as they might otherwise be. It might exacerbate the problem of waste of natural gas if you were able to buy gas for $1 MCF, say.

The fourth criterion that the Commission listed is that the rate should be appropriately flexible to changing conditions in the gas industry. I think that we have seen already the producers are willing to be flexible and change their rates.

We have had a majority of our contracts renegotiated, and we have seen producers continue to compete with spot market when gas is selling for a very inexpensive price.

The last comment I would like to make is that I think that while the Commision may be technically correct in their rebuttal comments that the block billing does not override State ratable take laws, I think the pipeline industry has certainly seen this as an opportunity.

Many of the pipelines in their comments to the FERC have openly called for, in essence, an overthrow of proration laws and protection of growth laws.

I think that is something that the Commission should consider, that regardless of how they interpret their rules, the pipelines have certainly taken a different interpretation.

Thank you, sir.

[The prepared statement of Mr. House follows:]

UNITED STATES OF AMERICA
BEFORE THE
SENATE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

REGULATION OF NATURAL GAS PIPELINES AFTER PARTIAL WELLHEAD DECONTROL	)	DOCKET NO. RM85-1-000 (PART D)

COMMENTS OF OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

The Oklahoma Independent Petroleum Association hereby submits its comments in response to the request of the Subcommittee.

I.
COMMUNICATIONS

All correspondence and communications relating to these proceedings should be directed to the following:

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II.
IDENTITY OF OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

The Oklahoma Independent Petroleum Association is the trade association that represents the interests of independent oil and gas producers active in the State of Oklahoma. The association has in excess of 1500 members.

III.
COMMENTS

The Oklahoma Independent Petroleum Association strongly opposes the Commission's block billing proposal. As discussed below, the elimination

II.
IDENTITY OF DESIGNATED PRODUCERS

The Oklahoma Independent Petroleum Association is the trade association that represents the interests of independent oil and gas producers active in the State of Oklahoma. The association has in excess of 1500 members.

Samson Resources Company is an independent producer of oil and gas with its principal place of business in Tulsa, Oklahoma. The company has extensive interests in oil and gas in Oklahoma, Arkansas, California, Texas and Louisiana, and operates numerous public drilling funds.

Grace Petroleum Corporation is an independent producer of oil and gas headquartered in Oklahoma City, Oklahoma. It is a wholly-owned subsidiary of W.R. Grace & Co., and has major oil and gas holdings in Alabama, Oklahoma, Texas, Mississippi and Louisiana.

Mark Producing, Inc. is an independent producer of oil and gas headquartered in Houston, Texas. Mark has major oil and gas holdings in the Outer Continental Shelf, offshore Texas and Louisiana, and onshore Texas, Louisiana and Ohio.

III.
COMMENTS

Designated Producers strongly oppose the Commission's block billing proposal. As discussed below, the elimination of full rolled-in pricing by interstate pipelines will not mitigate the market distortions resulting from the continued regulation of certain wellhead prices. To the contrary, the Commission's proposal would create additional distortions that would virtually guarantee a swing from the current surplus of gas deliverability to a shortage of gas supply. Designated Producers accordingly urge the Commission not to promulgate the proposed block billing rules, and to retain the current system of rolled-in pricing.

A. The Commission's Block Billing Proposal Would Not Mitigate Market Distortions in the Interstate Market

The Commission's arguments in support of block billing at pages 21-25 of the Notice fail in the context of the real, as opposed to a theoretical, marketplace. The Commission intends block billing to mitigate distortions in the marginal gas purchasing decisions of interstate pipeline customers and their downstream purchasers. But whose marginal decisions would be affected by the Commission's block billing proposal? The answer is: only those purchasers without access to Block 1 gas. The Commission appears to ignore the fact that the most significant purchasers of natural gas from interstate pipelines -- i.e., major distribution companies and large volume end-users that are the existing sales customers of the pipelines -- will have access to all below-market priced Block 1 gas, to the competitive disadvantage of other potential pipeline sales customers.

Block billing thus would not mitigate the distortive effects of regulated prices; it would merely shift the impact of this distortion to interstate pipelines' sales markets. Even in these markets, the purchasers who buy most of the gas sold by interstate pipelines would still have access to Block 1 gas, and would continue to be subject to the concomitant market distortions.

Moreover, block billing would not eliminate the competitive advantage afforded pipelines with low-cost gas cushions. To the contrary, the Commission's proposal to make low-cost gas supplies available only to pipelines' existing sales customers would enhance any competitive advantage that interstate pipelines with significant low-cost gas supplies may have over other marketers. These pipelines are virtually certain to retain their existing sales customers at full contract volumes by virtue of rates unreflective of market forces, thereby effectively precluding competition from other marketers for sales to this significant class of purchasers.

Block billing would have an additional distortive impact on competition among interstate pipelines. At page 23 of the Notice, the Commission concedes that "states might mandate that local distribution companies roll-in the price of block 1 and block 2 gas," with the result that "the ability of the block billing mechanism to discourage wasteful consumption would not be as great as it otherwise would be." As an initial matter, block billing will encourage, not discourage, wasteful consumption of Block 1 gas, as discussed below. Moreover, to the extent that some states allow local distribution companies to roll-in the price of gas supplies while other states do not, the marketability of Block 2 gas supplies will differ from state to state. The particular (and happenstance) mix of "block billing states" in which an interstate pipeline markets gas versus "rolled-in states" thus would give some pipelines a competitive advantage in marketing Block 2 supplies, which advantage would be wholly unrelated to efficient and economic pipeline operations.

Further, block billing would not allow the transmission of accurate price signals between the producing and consuming market segments. Making low-cost gas supplies available to only one class of customers would distort price signals to these customers to a far greater degree than the current practice of full rolled-in pricing. The average cost of all gas supplies obviously is more indicative of the market price of gas than the average cost of old gas alone.

Finally, because block billing would make lower-cost energy supplies available arbitrarily to existing customers of interstate pipelines, but not to their less fortunate competitors, the existing customers would be able to achieve a greater measure of profitability by virtue of federal regulatory fiat, not by virtue of more efficient or economic business operations. Similarly, existing pipeline customers would be encouraged to nominate as much Block 1 gas as they can while it is available, regardless of conservation principles.

The benefits of segregating all market-responsive gas prices into Block 2, as enumerated by the Commission at pages 21-23 of its Notice, may very well accrue with respect to purchasers that do not have access to Block 1 gas. However, with respect to all purchasers with access to Block 1 gas -- *i.e.*, the majority of interstate pipelines' markets -- block billing would not reflect the marginal valuation of gas, would not create a more level playing field on which interstate pipelines may compete and would not discourage wasteful consumption of natural gas. In short, block billing will exacerbate, not alleviate, the distortion of marginal gas purchasing decisions in the interstate market.

B. Block Billing Would Not Satisfy the Commission's Economic Criteria for Just and Reasonable Rates

The four economic criteria for just and reasonable rates listed by the Commission at pages 16-17 of the Notice will not be met by block billing under today's industry conditions. The first such criterion stipulated by the Commission is that the price should reflect the resource cost of bringing natural gas into the market. Moreover, according to the Commission, "an efficient price is one that relates current costs to current values." Designated Producers, however, can testify to the fact that purchasers of Block 2 gas are buying that gas at or near spot prices, and the spot prices currently being paid are not, in most cases, as great as the replacement cost of the gas being sold. Since the spot price does not relate current costs to current values, it cannot, by the Commission's definition, be considered an efficient price.

The second economic criterion noted by the Commission is that the rate permits fair competition "between pipelines or between a pipeline and a competing fuel supplier (either gas, oil or electricity)." This condition again indicates the Commission's failure or refusal to recognize the economic conditions prevalent in at least the producing segment of the industry today. Current spot prices represent competition at its keenest, not between pipelines but between producers, and the competition is based upon survival, not "fairness." Many of the producers whose marginal decisions the Commission would protect from the distorting effects of rolled-in pricing are more concerned with the effect that block billing would have on their current gas prices. Driving prices lower by implementing block billing, as proposed by the Commission, would increase this competition to the point that many producers would not survive. (This is a point to which the Commission referred at pages 58-59 of the Notice, but for the wrong reason.)

The third criterion is that a rate not lead to wasteful depletion of scarce, non-renewable resources. The Commission states in this connection that "consumers should not use up supplies of natural gas whose value is less than the cost of making those supplies available" and "should assure adequate supplies of natural gas at minimum cost to customers." However, block billing would make Block 1 gas available to some customers at an artificial, below-market rate, and Block 2 gas would sell at spot prices. Accordingly, the composite price of gas paid to producers would be below the spot market prices, and any wasteful depletion of natural gas which is occurring now will obviously be exacerbated. In other words, block billing would force consumers to use up supplies of natural gas whose value is less than the cost of making the supplies available. Thus, while block billing may assure supplies of natural gas at minimum cost to consumers in the short term, the duration of adequate supplies will be greatly diminished.

The fourth criterion listed by the Commission is that the rate should be appropriate to changing conditions in the natural gas industry. Changing conditions in the industry have already forced the price of gas down drastically. Any additional regulatory procedure that results in even lower prices paid to producers will inhibit investment in the production business, and endanger the availability of adequate gas supplies.

In this connection, Designated Producers would point out that Congress passed the Natural Gas Policy Act of 1978 ("NGPA") in major part because the maximum wellhead price allowed under the Natural Gas Act for gas sold in interstate commerce at the time was insufficient to elicit exploration, development and dedication of supplies to the interstate market. That price, adjusted for inflation, currently is equivalent to the NGPA Section 109 price, or $2.52 per MMBtu in October 1985, and spot sales are below this price. History should counsel the Commission not to add fuel to the fire by driving wellhead prices down further than the market is doing on its own; as an economic reality, there is a point at which many producers will be forced to stop exploration and development efforts.

In short, the Commission's block billing proposal would not result in just and reasonable rates. It would create distortions in the marginal decisions of producers that would lead inevitably to a new shortage of gas supplies.

C. The Elimination of Full Rolled-In Pricing Is Not Necessary

In its Notice, the Commission suggests that distortions in the natural gas market have been caused in significant degree by "rolling in very disparate prices" for natural gas. Notice at 18. However, it is the availability of gas at prices kept artificially below market prices by regulation that is the real source of market inefficiencies, not rolled-in pricing. Until supplies of this artificially low-priced gas are depleted (or the price is made to be market responsive), any market participant that has access to these gas supplies will continue to realize an economic advantage over competitors that do not have the same access.

The Commission's conclusion that full rolled-in pricing should be eliminated apparently is based in part on the market's historical experience with the effect of rolled-in pricing. See Notice at 41-46. It is interesting to note that the Commission, in its fervor to justify block billing, hypothesizes that high gas prices would not have followed enactment of the NGPA had block billing been in effect at the time. Designated Producers submit that, had block billing been in effect in 1978, the shortage of gas which existed at the time would have continued, probably to the present, and that while some deep wells might not have been drilled, the price of new gas categories would have surely increased on January 1, 1985.

In any event, the industry's past experience with full rolled-in pricing in an era of pervasive wellhead price control simply is not relevant to the current market. With the deregulation of most wellhead prices effective January 1, 1985, the categories of gas with prices regulated at below-market levels are limited, and their reserves are finite. As these reserves gradually deplete, the distortive effect of their below-market prices will diminish.

Further, the Commission's statement that rolled-in pricing permits a pipeline with an old-gas price cushion to purchase incremental supplies at above-market prices may be theoretically correct. But as a matter of fact -- not theory -- interstate pipelines are not contracting for new gas supplies at above-market prices, regardless of how deep their low-cost gas cushion may be. Notwithstanding full rolled-in pricing of pipeline supplies, the market currently is functioning to allow the transmission of accurate price signals among market participants, and the market will continue to become more efficient as low-cost gas reserves are depleted. Consequently, the elimination of full rolled-in pricing is not necessary.

IV.

CONCLUSION

Just as the natural gas industry is beginning to work its own way out of the market distortions created by wellhead price regulation, the Commission proposes to introduce drastically revised interstate pipeline rate regulation on the basis of elaborate economic theory. See Notice at Exhibit S. Designated Producers decline to participate in a scenario of dueling economists, all attempting to justify their own natural gas supply and demand models. The Commission is not regulating in a vacuum, but in a real and dynamic marketplace.

As active participants in that marketplace, Designated Producers can testify that, notwithstanding full rolled-in pricing, market participants are responding to competitive market forces in their efforts to negotiate new sales and purchases of gas on the one hand, and to live up to their existing contracts, on the other. Block billing would disrupt this process, without any promise of benefit. Designated Producers accordingly urge the Commission not to promulgate its block billing rules: they will do more harm than good.

Respectfully submitted,

David W. House

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Chairman, Natural Gas Committee
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

November 27, 1985

Senator NICKLES. Thank you very much.

Our next panelist, we have Mr. Bryan Whitworth, vice president of government relations, Phillips Petroleum.

STATEMENT OF J. BRYAN WHITWORTH, VICE PRESIDENT, GOVERNMENT RELATIONS, PHILLIPS PETROLEUM CO.

Mr. WHITWORTH. Thank you, Mr. Chairman.

My name is Bryan Whitworth, and I am vice president of Phillips Petroleum Co., residing in Bartlesville.

Phillips is both a producer and purchaser of natural gas. In 1984, Phillips produced an average of 70 million cubic feet per day of gas within the State of Oklahoma.

Senator Nickles, we are most appreciative of your efforts to bring this hearing to the State. The economy of Oklahoma is dependent to a large degree on revenues derived from the oil and gas industry.

Today, spot market prices paid for natural gas at the wellhead are lower in Oklahoma than in any other State. Correspondingly, Oklahomans are well aware that our State economy is down significantly from the levels of the past several years.

Moreover, the prospects for improvement in the near term are not encouraging. Mindful of these conditions and because of the serious detrimental effects to the long-term supplies of natural gas, Phillips opposes the effort by the FERC to impose block billing on the gas industry.

We submit that a nondiscriminatory transportation policy, with decontrol of all natural gas prices and the elimination of end-use restrictions, is the only means by which consumers will receive maximum supplies of gas at reasonable prices.

I would like to address briefly two specific areas of the FERC rulemaking which are of concern to us, part A and part B, dealing with transportation and block billing, respectively.

The transportation provisions attempt to create a voluntary transportation program, whereby all the Nation's consumers would benefit from greater access to natural gas supplies at competitive prices.

Our concern stems not from FERC's implementation of the nondiscriminatory transportation program, but from the failure of much of the transportation industry to participate in the program.

Phillips has to date lost approximately 75 million cubic feet of gas sales. Some of our pipeline customers were continuing to take deliveries for system supply purposes through the first week in November. However, since that time, we have been notified that our deliveries will be curtailed an additional 85 million cubic feet per day, bringing it to the total of 160 million cubic feet per day.

At this point it appears that Phillips' major pipeline transporters will not seek blanket transportation certificates. If the transportation rule adopted by the FERC proves to be unsuccessful because the pipelines are not willing to participate in the program, then, clearly, either the FERC or preferably the Congress must review the program in order to protect the interest of the consumer.

With respect to block billing, we oppose the program because we recognize that it may result in perhaps some short-term benefits to some producers, but that the long-term impact to consumers and to pipelines and producers will be negative.

The major result we see from block billing is that over the long term the natural gas industry could be seeing a return to the dual-pricing system between interstate and intrastate sales.

We see reduced incentives to producers to explore for new gas because revenues will decline in the block 2 gas.

We anticipate that block billing could result in higher prices at the burner tip to some customers. There will also be lost revenues to producing States from lower severance taxes.

We also foresee significant inequities among customers and regions of the country. We also anticipate that there will be added complexities when the State regulatory commissions and the local distribution companies begin to grapple with the many problems which will arise from block billing.

Moreover, block billing will stress consumption of forever regulated gas at the low market prices. This will lead to declining reserves, possible future shortages, and higher prices. It will not create a level playing field as anticipated by the FERC.

Also, contrary to the Commission's assumption that block billing will enhance competition among pipelines, we believe the opposite will occur as those pipelines with large reserves of old gas will have higher throughputs and, hence, lower unit costs.

With respect to the State of Oklahoma, we believe that the impact will be substantial. We are aware of recent studies that have been completed by the industry, as well as academic researchers, that have analyzed the impact of block billing on the various States.

Those studies indicate that the impact to Oklahoma from lost State severance taxes would be in the range of $20 million, possibly up to $90 million.

Mr. Chairman, I also want to note that this past week the Department of Energy sent a proposal to the FERC concerning old gas. We are still in the process of reviewing that proposal.

I understand that in that proposal that DOE is recommending the elimination of vintaging. We commend DOE for taking this action and believe that FERC should adopt a reasonable and just price for old gas that is related to the marketplace.

Since Federal wellhead price controls were first placed on gas in 1954, the natural gas marketplace has been plagued with problems. As each market distortion has arisen, the Congress has approached a solution with a possible Band-Aid addition. These solutions have, if anything, brought further distortions to the gas business.

Much of the NOPR and order 436 is, in fact, an effort to address problems arising from the Natural Gas Policy Act of 1978. However, we believe that the response will be no more successful than past efforts to control and regulate the natural gas industry.

In summary, Mr. Chairman, natural gas remains the only energy commodity in the United States that is still under controls. We believe that S. 1302, which you have previously introduced, is a step in the right direction to free the natural gas industry so that it can respond to the competitive forces of the marketplace.

The present gas market conditions provide excellent timing for total decontrol of all gas, as well as repeal of the Fuel Use Act.

Wellhead prices are decreasing and, in turn, the weighted average cost of gas for major interstate pipelines has declined.

Yet, residential prices for the first 6 months of 1985 have, on a national average, have increased 12 cents per million cubic feet over the same period.

This condition alone indicates that continued controls throughout the business are not benefiting the consumers of this country. We believe that consumers can only be assured of adequate gas supplies at fair market prices by allowing the natural gas industry to return to a totally noncompetitive market driven by simple supply and demand.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Whitworth follows:]

TESTIMONY OF

J. BRYAN WHITWORTH
PHILLIPS PETROLEUM COMPANY

BEFORE THE

SUBCOMMITTEE ON ENERGY REGULATION
AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES

U.S. SENATE

TULSA, OKLAHOMA
NOVEMBER 27, 1985

Thank you, Mr. Chairman. My name is Bryan Whitworth. I am a Vice President with Phillips Petroleum Company, and reside in Bartlesville, Oklahoma, where Phillips was founded in 1917. Phillips is both a producer and purchaser of natural gas. Much of the gas we produce and purchase is processed to extract natural gas liquids prior to sale to gas pipelines. In 1984, Phillips produced an average of 70 MMCF of gas per day in Oklahoma, purchased an additional 347 MMCF per day, and sold an average of 310 MMCF per day to inter and intrastate transmission pipelines. In the first nine months of 1985, we have produced, on a national basis, an average of 917 MMCF of gas per day.

Senator Nickles, we are most appreciative of your efforts to bring this hearing to Oklahoma. The economy of Oklahoma is dependent to a large degree on revenues derived from the oil and gas industry. Today, spot market prices paid for natural gas at the wellhead are lower in Oklahoma than in any other producing state. Correspondingly, Oklahomans are well aware that our state economy is down significantly from levels of the past several years. Moreover, the prospects for improvement in the near term are not encouraging. Mindful of these conditions, and because of the serious detrimental effects to the long-term supplies of natural gas, Phillips opposes the effort by the Federal Energy Regulatory Commission (FERC) to impose block billing on the gas industry. We submit that a non-discriminatory transportation program, with decontrol of all natural gas prices and the elimination of end-use restrictions, is the only means by which consumers will receive maximum supplies of gas at reasonable prices.

FERC's NOPR

The federal government's regulatory policies affecting natural gas continue to prevent the marketplace from determining the viability of the gas industry. The FERC's recent Notice of Proposed Rulemaking (NOPR), which has now been partially implemented (Order No. 436), has added to the problems in the natural gas industry, and created another intrusion into the marketplace by government.

Phillips believes that the FERC's intentions, when the NOPR was first issued, were laudible, and were designed, at least in part, to remove inequities in the gas industry. However, it is apparent that the comprehensive NOPR and even Order 436 are not real solutions to the many problems which exist within the already highly regulated gas industry.

Many of the elements contained in the NOPR reflect an effort by FERC to provide the natural gas industry with a program which would guarantee a ready supply of natural gas at competitive rates. Some beneficial elements of Order 436 include:

- A transportation program which, if utilized by pipelines, would provide open access to all available gas supplies for end users.
- A procedure for producers and pipelines to freely resolve contractual take or pay problems with a minimum of government interference.
- Expedited procedures for abandonment of that gas released by a pipeline.

A closer review of the lengthy rulemaking has, however, raised a number of major concerns in our industry. I would like to discuss two specific concerns: these are Parts A and D which deal with transportation and block billing, respectively.

Transportation

Part A of FERC's Order 436 attempts to create a voluntary transportation program whereby all of the Nation's consumers would benefit from a greater access to natural gas supplies at competitive prices. This transportation program also provides pipelines with the opportunity to make a fair return on their investments in a competitive environment while allowing producers the opportunity to expand their sales through direct access to new markets.

Phillips applauds the Commission in implementing this program, in that it brings the first sense of competition to the transportation industry since 1938. Our concern stems not from FERC's implementation of the non-discriminatory transportation program, but from the failure of much of the transportation industry to participate in the program. In fact, a number of pipelines have indicated that they will not become transporters under Order 436. As a result of the implementation of Order 436, Phillips has to date lost approximately 77 MMCFD of gas sales. Some of our pipeline customers were continuing to take deliveries for system supply purposes through the first week in November. However, since that time, we have been notified that our deliveries will be curtailed an additional 85 MMCFD per day. At this point, it appears that Phillips' major pipeline transporters will not seek blanket transportation certificates under Order No. 436, at least not before mid-1986. As a result, Phillips is moving approximately 160 MMCFD less gas to consumers than we were a month ago.

We should point out that Phillips, over the past couple of years, has worked to alleviate contract problems and have negotiated, in good faith, with our pipeline customers to continue to provide to consumers supplies of natural gas at reasonable, competitive market clearing level prices.

The absence of an equal access transportation program points out one obvious problem which is detrimental to consumers: There are willing buyers of additional gas reserves and there are producers ready to meet their needs and, in many instances, at a lower price. The component preventing these parties from making an agreement is transportation. If the transportation rule adopted by FERC proves to be unsuccessful because the pipelines are not willing to participate in the program, then clearly either FERC or preferably the Congress must review the program in order to protect the interest of the consumer. Obviously, a legislative solution that stipulates mandatory contract carriage would be the most straightforward method to address this problem.

Block Billing

Part D of the NOPR, which contains the block billing concept, is one of the most controversial aspects of the NOPR. Recently, FERC delayed implementation of this provision in order to better determine its potential impact on the natural gas marketplace.

Senator Nickles, we are appreciative of your role in helping delay the implementation of Part D so that affected parties might analyze it more thoroughly.

As drafted, the block billing provision divides natural gas into two blocks. For block one, FERC selectively picks all Section 104, 106 (a) and 109 gas for inclusion in the "old gas" block. These gas categories are forever regulated at the cheapest rates. However, the NOPR omits from block one Section 108 (stripper), 102 (d) (new gas from an old OCS lease), and 103 (committed or dedicated interstate on April 20, 1977) gas which are also forever regulated categories. The reason that some forever regulated gas is omitted from block one is that their regulated rate is higher and inclusion of the higher regulated rates would bring block one prices closer to the proposed block two category, which contains all other gas, including imports. In essence, cheaper, old gas supplies are segregated from newer, higher cost supplies. This very segregation of controlled old gas supplies from all remaining categories will, in our opinion, over the long-term cause increased prices for natural gas, and lead to supply distortions in the marketplace.

Phillips recognizes that the implementation of block billing, as recently modified, could provide some short-term benefits depending on a producer's old gas reserves. Some producers who enjoy large old gas reserves could see a near-term increase in cash flow as a result of a possible increase in demand for cheaper, block one gas. However, if such a short-term benefit exists, it is our view that the long-term negative effects of block billing to consumers, producers, and pipelines greatly exceed any possible short-term benefits to any one segment of the gas market.

The concept of block billing, as set forth in Part D, has numerous negative aspects. First, the manner in which block billing is structured will lead to increased demand for price-controlled gas in block one with a corresponding decrease in demand for block two gas. This decrease in demand for block two gas will, in the long-term likely result in reduced exploration activities.

I do not need to remind anyone here that the gas business has already undergone significant curtailment. According to the Energy Information Agency's reserve estimates, gas reserves declined 3 trillion feet during 1984, reaching their lowest level on record. This continues the downward trend we've seen since 1981, which was the last year the nation's natural gas industry replaced the reserves it produced. The story in 1985 will likely be worse, because as a result of falling prices, the number of drilling rigs in operation developing new gas supplies is down dramatically. In 1981, an average of 3,970 rigs were in the field, compared to about 1,840 reported for October of this year; a 54% decrease.

Block billing will make this situation worse because it will further reduce the flow of capital required by producers to replace the gas supplies consumed. The industry needs to continue to look for new reserves. In 1984, new reserve additions equaled only 78% of production. Domestically, production has outpaced new discoveries annually for the past 18 years, not counting Alaska's Prudhoe Bay. Our reserves to production ratio during this period has dropped from 13.4 to 9.6 years. Reserves to production ratios are the real index of supply, not the surplus of deliverability existing today. A reduction in new exploration would come at a time when the natural gas supply situation has worsened substantially.

In summary, the longer term impact of block billing, which stresses consumption at below market prices, can only assure that which we have said before - future natural gas shortages and higher consumer prices will prevail.

Second, block billing will lead to a new system of price distortions in the marketplace. Certain pipeline customers will have greater access to cheaper gas solely because of historical purchases and availability of block one gas to their pipeline-suppliers. Block billing, as it is presently structured, differentiates between groups of consumers as well as regions of the country by virtue of its pricing mechanism. In theory, those gas users serviced by pipelines with access to old gas supplies could enjoy prices well below the market clearing price for gas, while gas users on pipeline systems utilizing block two gas will pay higher prices. New entrants to the natural gas market will have limited or no access to block one gas. This barrier will provide historical customers an unfair competitive advantage that will negatively impact the new entrant. Thus, an industrial plant that started purchasing gas during the past several years in response to its new availability and price stability, or even a proposed new start-up plant, could suddenly find itself at an increased price disadvantage relative to a competing plant of a historical customer of the same or a deeper cushion pipeline.

Complicating this situation is that, in practice, there is a real possibility that even the historical customer may not realize any actual benefits from block billing, since the proposed rule transfers the pricing decision (as to whether to carry block pricing) from the federal government to the local distribution companies (LDCs) and the state regulatory commissions. The distribution of gas by the local distribution company is subject to the jurisdiction of the state's public utility commission. It is entirely possible that 48 states could promulgate 48 different policies to deal with the allocation of the "old gas" supplies and the historical customer defined by FERC may not be the same historical customer defined at the state or local level. Thus, FERC has not facilitated the transmission of market signals from the wellhead to the burner tip, but has only displaced the problem to the local level. It is even conceivable that some price discrepancies will occur within the same communities where different LDCs are involved. FERC's proposal also does not prevent the LDCs from capturing for themselves the lower block one prices by increasing their margins rather than passing along lower prices to the consumer. Thus, while block billing may provide some short-term, artificially low gas prices to some consumers, it will, in fact, at the same time raise prices for a significant number of consumers. This contradicts the stated goal of the NOPR.

Third, block billing will not create competitive equality among pipelines. The Commission based its decision to institute block billing partly on its assumption that block billing would enhance competition because pipelines would no longer be permitted to use rolled-in pricing. Pipelines with large reserves of old gas would, theoretically no longer have a competitive edge.

This argument fails to recognize the fact that those pipelines with a large old gas cushion will be assured of higher sales because larger amounts of block one gas will be in demand by their consumers. Therefore, these pipelines will achieve high throughputs and hence lower per-unit costs than other pipelines, because the higher the volumes through, the less it costs to move each increment of volume. These lower transportation costs translate into a competitive advantage.

Impact of Block Billing on Oklahoma

We are aware of several recent studies that have been completed both within the industry as well as by academic researchers that have analyzed the impact of block billing on the states. It is clear that the producing states would be negatively impacted by this proposal. For example, several reports show impacts to Oklahoma from lost state severence taxes that range from about $20 million up to $90 million. Also, since block billing will have an adverse effect on royalty owners, we would expect an increase in royalty demands which could possibly result in litigation or the expectation that the producer will bear these costs out-of-pocket. Further, when producers take new leases, absent the new gas prices, they might encounter demands from landowners for increased royalty percentages.

In addition, on November 18, Phillips filed additional comments with FERC expressing our belief that block billing will result in a return to a dual pricing market between interstate and intrastate sales of natural gas. The dual market will arise as a result of the elimination of rolled-in pricing by the interstate pipeline purchasers, whereas, the intrastate purchasers will still be able to roll-in more expensive new gas because of their cushions of old gas supplies. In its May 30, 1985, Notice of Proposed Rulemaking, FERC acknowledged that one of the purposes of Congress in enacting the Natural Gas Policy Act was to eliminate this dual market situation. Attached, as an Exhibit to this statement, are our filed comments which provide more detail on this concern and its particular impact on Oklahoma. Specifically, it is our view that:

- Substantial volumes of old gas are now being used in the intrastate market on a rolled-in basis to lower the overall average cost of gas to intrastate consumers, but block billing will cause interstate pipelines to increase their maximum takes of old gas (block one), thereby displacing block two gas and forcing the average price of block two gas down to market clearing levels.

- If block one gas volumes displace block two gas volumes in the interstate market, then the displaced block two gas must either be shut-in or seek a new home in the intrastate market.

- In Oklahoma, as a result of the elimination of rolled-in pricing, it is anticipated that substantial volumes of block two gas currently being sold in the interstate market from Oklahoma will be displaced by block one gas supplies being produced from other states. Oklahoma's intrastate market is based on industrial uses (mainly fertilizer plants) and electrical power generation, and the states total consumption has remained fairly constant at 650 to 710 BCF per year. Thus, the Oklahoma block two gas which is displaced in the interstate market and cannot be consumed in the intrastate market will be shut-in at the wellhead. Of course, this affects Oklahoma revenues, employment, producers' cash flows and corresponding exploration activities.

Two weeks ago, Billy Hamilton, Assistant Comptroller for the State of Texas, in testifying before a House Committee on the NOPR, provided some alarming figures which show how devastating block billing can be to a state's economy. The following text is lifted from Mr. Hamilton's testimony:

> "Today, a third of Texas' interstate gas production falls into the low-priced Block 1. The average price of gas is about $1.57 per MCF. Texas gas in Block 2 carries an estimated average price of about $2.86 per MCF at the wellhead. The overall average price of Texas gas—interstate and intrastate markets combined—is expected to average about $2.40 per MCF during this state fiscal year (September 1985-August 1986), below national average prices.
>
> Our estimates show that block billing, along with other FERC rules already adopted, would push the average price of Block 2 gas down to $2 per MCF or lower. This would represent an annual loss of over $2.5 billion in income to Texas gas producers and a related annual loss of as much as $200 million in state severance taxes."

In summarizing this subject, it would appear to us that it is not wise to implement a policy which at least one study shows would provide Ohio with a gain of $506 million while draining $585 million from the State of California. It is particularly ironic that consumers from the very regions of the country containing the vast majority of old, forever-regulated gas reserves, find themselves on the list of losers under a block billing program. Much of the same scenario could be applicable to Oklahoma.

DOE Proposed Rulemaking On Old Gas

Mr. Chairman, we also want to note that just last week, the Department of Energy sent a proposal to FERC concerning old gas. While Phillips is now reviewing the details of this proposal, I understand that DOE is recommending the elimination of vintaging. We commend DOE for taking this action, and believe FERC should adopt a just and reasonable price for old gas that is related to the market price.

The Need for Decontrol

Mr. Chairman, there is an old saying that if you tell people the same thing long enough, then they will begin to believe it. I don't believe that the person who penned that saying ever heard of industry's thirty year pleading to Congress to decontrol all natural gas.

Since federal wellhead price controls were first placed on gas in 1954, the natural gas marketplace has been plagued with problems. As each market distortion has arisen, Congress has reacted with a "band aid solution." These "solutions" have, if anything, brought further distortions to the gas business. Much of the NOPR and Order 436 is, in fact, an effort to address problems arising from the Natural Gas Policy Act of 1978. However, we believe that this response will be no more successful than past government efforts to control and regulate the natural gas industry.

The final decontrol of crude oil in 1981 and the partial decontrol of natural gas in January of this year have proven that those who predicted price "fly ups" in wellhead prices from such events were wrong. In fact, wellhead gas prices have actually decreased since January.

Mr. Chairman, natural gas remains the only commodity under price controls. We believe that S.1302, which you have previously introduced, is a step in the right direction to free-up the natural gas industry so that it can respond to the competitive forces of the market place. The present gas market conditions provide excellent timing for total decontrol of all gas, as well as repeal of the Fuel Use Act. Wellhead prices are decreasing, and in turn, the weighted average cost of gas for major interstate pipelines has declined. Yet residential prices for the first six months of 1985 have, on a national average, increased 12 cents over the same period in 1984. This condition alone, indicates that continued controls throughout the business are not benefitting the consumers of this country. We believe that consumers can only be assured of adequate gas supplies at fair market prices by allowing the natural gas industry to return to a totally competitive market driven by simple supply and demand. Thank you.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas	)	
Pipelines After Partial	)	Docket No. RM85-1-000
Wellhead Decontrol	)	(Part D)

SUPPLEMENTAL COMMENTS OF PHILLIPS PETROLEUM COMPANY

Phillips Petroleum Company (Phillips) submits these comments in response to the Notice requesting supplemental comments on the proposed Block Billing regulation and in addition to the comments submitted by Phillips as one of the Indicated Producers.

Phillips believes Block Billing is not a viable solution to the problems confronting the natural gas industry and will not accomplish the Commission's objectives "to ensure that the natural gas markets are viably and sufficiently competitive so that consumers are provided natural gas at the lowest reasonable rates consistent with reliable long term service".[1] Phillips, like others, believes the only real solution to the gas industry's problems is actual decontrol of prices at the wellhead; however, since the Commission lacks authority to decontrol wellhead prices, Phillips urges the Commission do the next best thing and exercise its authority under the Natural Gas Policy Act to raise ceiling prices on all "old gas" to the market clearing levels under the just and reasonable rates standards.

1/ Notice of Proposed Rulemaking, May 30, 1985, at 3.

Phillips is concerned that the Commission in its attempts to "fix" the natural gas market by creating a "level playing field" and reserving "old gas" supplies to historical customers of interstate pipelines may, in fact, create gross price distortions between the interstate and intrastate markets. The Commission in its May 30, 1985, Notice of Proposed Rulemaking acknowledged that one of the purposes of Congress in enacting the NGPA was to "eliminate the dual market that distinguished between interstate and intrastate sales of natural gas".[2]

Phillips believes Block Billing may turn the clock back and foster the creation of a dual inter-intrastate market for natural gas. The "cushion" of "old gas" dedicated to interstate pipelines and reserved under Block Billing to the interstate pipelines historical customers may create the price anomalies which Congress tried to eliminate with passage of the NGPA.

The intrastate natural gas market accounts for approximately 40 percent of the country's natural gas production, with Oklahoma, Louisiana and Texas comprising approximately 70 percent of the production.[3] The intrastate markets are unique and are far from homogeneous. Characteristically, the markets evolved over different periods of time as gas reserves were developed under differing state laws and regulations. Notably absent until the passage of the NGPA, were any form of State or Federal price controls.

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[2] Supra, at 11.

[3] Energy Information Administration, U.S. Dept. of Energy, Producer Revenues, Prices & Concentration in the Natural Gas Market, DOE/EIA - 0404, at 11. (Table 5)

In 1978, when the NGPA was enacted, the average price of intrastate gas was $1.34 MMBtu as compared to an interstate price of $0.91 MMBtu.[4] The Energy Information Administration (EIA) recently estimated that as much as 42 percent of the pre-NGPA intrastate contract volumes are subject to contracts which do not expire until after 1990.[5]

Although, the pre-NGPA intrastate contracts are for extended terms, much like the "cushion" of "old gas" held by the interstate pipelines, approximately 41 percent of the intrastate flowing volumes do not contain indefinite price escalation clauses.[6] It can be surmised that substantial volumes, maybe as much as 1.3 Tcf based on an 8 Tcf market, of inexpensive ($0.52 MMBtu) "old gas" are being used in the intrastate market on a rolled-in basis to lower the overall average cost of gas to intrastate consumers.[7]

It is generally conceded by the Commission and others, that Block Billing will force down interstate gas prices in the short term; however, there appears to be a void as to an analysis of Block Billing on the intrastate market. It is anticipated that the interstate pipelines will increase their maximum takes of currently shut-in Block 1 or "old gas", thereby displacing volumes of Block 2 gas and forcing the average price of the

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[4] Supra, at 14. (Table 6)

[5] Energy Information Administration, U.S. Dept. of Energy, Structure and Trends in Natural Gas Wellhead Contracts, DOE/EIA - 0419, at 25. (Table 7)

[6] Energy Information Administration, U.S. Dept. of Energy, Natural Gas Producer/Purchaser Contracts and Their Potential Impact on the Natural Gas Market, DOE/EIA - 0330, at 23.

[7] Supra, at 24. (Table 5)

Block 2 gas down to the spot market clearing level. Market factors such as gas on gas competition, off system sales and declining crude oil prices have caused the spot market price for "new gas" at the wellhead to $1.85 - $2.00 per MMBtu.[8]

If Block 1 gas volumes displaces Block 2 gas volumes in the interstate market, then the displaced Block 2 gas must either be shut-in or seek a new home in the intrastate market. The displaced Block 2 gas that finds its way into the intrastate market will primarily be the spot market gas which has been estimated to constitute as much as 20 percent of the interstate gas currently flowing. This is based on the assumption that "old gas" will constitute more than 50 percent of the interstate supply and that approximately 20 percent of the interstate pipelines' gas purchase contracts are non-market sensitive §102 or §107 contracts.[9]

If the displaced Block 2 gas is priced at the spot market level in the intrastate market, then a new vintage of gas will be created - that which once was flowing interstate, is no longer flowing and is now intrastate gas. The Block 2 gas entering the intrastate market will affect each state differently; however, it is likely that intrastate gas prices will decline in the short term. Approximately 25 percent of all intrastate sales contracts will expire between now and 1990; however, in the two largest intrastate markets, Texas and Louisiana, all but one-third

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8/ Natural Gas Intelligence

9/ Energy Information Administration, U.S. Dept. of Energy, Natural Gas Monthly, DOE/EIA - 0130 (85/08) and Foster Associates, Inc., Analysis of High Cost Purchases by Contract Termination Date, prepared for the American Gas Association, Aug., 1985.

of the long term pre-NGPA contracts will have expired by 1990. In Oklahoma, the third largest intrastate market, approximately 75 percent of the pre-NGPA long term contracts will still be in effect after 1990 10/

As the long term contracts expire, the intrastate purchasers will use their "cushions" of "old gas" supplies to bid up the price, once again in excess of the price paid by interstate consumers. The ability of the intrastate purchaser to bid up the price in excess of the interstate consumer is dependent on his access to gas, cost of transmission and distribution, availability of competitive fuels, "old gas" cushion and the elimination of the rolled-in purchasing practices of the interstate pipelines.

Given the nature of the intrastate markets, the full impact of Block Billing cannot be predicted with any degree of certainty; however, some states will be impacted more than others. For instance, Oklahoma ranks third among the states in the production of natural gas with approximately two-thirds of its production being sold into the interstate market. It has been estimated by Dr. William Tally III of the Oklahoma City, RAM Group, in a private client study that the state has an oversupply deliverability of 2 - 3.1 Bcf per day. In the past, some of the intrastate surplus was sold by the intrastate pipelines and producers to the interstate pipelines or in interstate Special Marketing Programs; however, much of the gas was shut-in due to lack of transportation facilities and markets.

As a result of Block Billing, and the elimination of rolled-in pricing, it is anticipated that substantial volumes of Block 2 gas currently being sold in the interstate market from Oklahoma will be displaced by Block 1 gas supplies being produced from other states. Oklahoma's intrastate market is based on industrial uses (mainly fertilizer plants) and electrical

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10/ Energy Information Administration, U.S. Dept. of Energy, Structure and Trends in Natural Gas Wellhead Contracts, DOE/EIA - 0419, at 25.

power generation. The states total consumption has remained fairly constant at 650 - 710 Bcf per year. Thus, the Oklahoma Block 2 gas which is displaced in the interstate market and cannot be consumed in the intrastate market will be shut-in at the wellhead. Of course, this affects Oklahoma revenues, employment, producers cash flows and corresponding exploration activities, etc.

Block Billing will affect the Texas and Louisiana markets much differently than Oklahoma. The Texas Gulf Coast is the largest industrial and electric utility gas market in the country. Prices in the intrastate Texas market have been under bombardment for the past couple of years as a result of the interstate pipelines off system sales practices. The interstate pipelines have used their cushions of "old gas" to penetrate the intrastate market at the expense of the intrastate pipelines.

In 1984, Fosters Associates, Inc. in a multi-client study, made a comparison of the commodity rates with actual sales prices for a selected group of interstate and intrastate pipelines.[11/] Foster's study revealed that the interstate pipelines had a $0.78 MMBtu sales advantage over the intrastate pipelines in 1983, and on the average paid $0.68 MMBtu more at the wellhead for gas supplies than the intrastate pipeline. The WACOGS of the pipelines revealed that the interstate pipelines had a $0.74 and $0.93 advantage over the intrastate pipelines for the years 1983 and 1984 respectively. Under the Commission's theory, this advantage, of course, is believed to be as a result of the selected interstate pipelines having a greater cushion of "old gas" than the intrastate pipelines.

[11/] Fosters Associates, Inc., The Impact of Deregulation on Natural Gas Pipelines, Prices and Markets, 1985 - 1990, September, 1984.

The NGPA was designed to eliminate the price disparities between the inter and intrastate markets; however, the Foster report raises questions as to the degree of success of the NGPA in accomplishing Congress' objective. Block Billing will eliminate the interstate pipelines apparent advantage over the intrastate pipelines in acquiring gas supplies; however, the "cushion" of "old gas" available to the intrastate pipelines and the direct sales customers will permit the intrastate market to bid-up the price of gas beyond that of the interstate market. The unknown factor in the bid for future gas supplies will be what allowance the state public service commissions make for local distribution companies to use rolled-in pricing to acquire new or additional gas supplies.

Phillips believes the Commission has tilted the playing field with the Block Billing concept. The potential disruption of the intrastate gas market, the economic hardships likely to fall on the high cost gas producing regions of the country and creation of shortages in the interstate market in the future cannot be justified solely on the basis that rolled-in pricing distorts the transmission of market signals from the wellhead to the burner tip. The Commission should abandon Block Billing and use its authority to raise old gas prices.

Respectfully Submitted,

By:________________________
Earl David
Government Relations Representative
Phillips Petroleum Company
Bartlesville, Oklahoma

November 18, 1985

Senator NICKLES. Mr. Whitworth, thank you very much.

Our next panelist, Mr. Dar, president of Hadson Gas Systems.

STATEMENT OF VINOD K. DAR, PRESIDENT, HADSON GAS SYSTEMS

Mr. DAR. Good morning, Senator. Good morning, ladies and gentlemen.

Thank you, Senator, for listening to the Oklahoma independents. You seem to be one of the few people who still believe that the small company has a place in American life.

Thank you, also, for your uncompromising support of the free enterprise system, a concept that seems alien and frightening to some in the gas industry.

I have a prepared statement, but before I go into that, a brief comment on block billing. As I understand, your aversion to block billing is that it does not create a level playing field.

Many other people have an aversion to block billing. Our suggestion is that if Congress does not like block billing, there is a simple solution—total, immediate, and unqualified decontrol of all gas. That will indeed create a level playing field and should accomplish both the economic and the equity objectives that the FERC, the DOE had advocated.

Block billing probably will not accomplish those objectives. It is a second-best solution to a nonproblem which could be eliminated by decontrol of all gas.

On October 6, Senator, I went to have dinner at a Chinese restaurant with my wife in Oklahoma City. At the end of the dinner you get the fortune cookie. I opened it and it said, "The tide of change approaches." The next day FERC issued its final rule on gas.

We call it the "F-r-o-g," FERC's "Frog," and like it or not, we all have to kiss FERC's "Frog." Some people in the industry think that by kissing the frog, the industry will be transformed into a fairy prince. Actually, if we have conventional tastes, we hope it is a fairy princess.

Others in the industry think that by kissing the frog, you are going to get warts. I do not think there is really a realistic way out, other than kissing the frog, of making sure that after the kiss we do get a fairy prince and not warts.

There is much in what the FERC has proposed which we find sensible, especially when it comes to open access. Hadson is an Oklahoma independent consisting of Hadson Petroleum Corp., Hadson Petroleum International, and Hadson Gas Systems.

We are independent, publicly traded, based in Oklahoma City, active in domestic and international oil exploration, domestic oil and gas production, gas gathering, and gas marketing.

Hadson Gas Systems owns and operates 9 gas-gathering systems and, as of November 15, had 56 direct sales contracts with industrial gas users and local gas distribution companies.

There are some people in the industry who wish we had none and they are trying to make certain we do not.

Hadson Gas Systems enthusiastically endorses the FERC's open access provisions, because we believe that this will foster a competitive gas industry.

FERC's move toward open access will bring to millions of gas consumers around the Nation the benefits of competition and afford hundreds of entrepreneurial gas producers, gatherers, and marketers the business opportunities inherent in a free, competitive, and fair gas market.

The FERC, for all its faults, and sometimes I feel that they get their knowledge of the oil and gas industry, Senator, by watching reruns of the "Beverly Hillbillies," but for all its faults, the FERC recognizes that the key to competition in the gas industry is fair and just long-distance gas transportation by interstate pipelines.

The gross abuse of monopoly power by interstate pipelines who are denying transportation is having a devastating impact on the Oklahoma independent. As a consequence of the economic terrorism practiced by interstate pipelines, Hadson Gas Systems is moving about 100 million cubic feet a day less Oklahoma gas to its customers than it otherwise would.

Although we have made up some of this from Louisiana, the vast majority of this gas is not going to customers. The wells are shut in. The producers are not getting cash flow and the customer has either been forced to switch to fuel oil or seriously contemplate curtailing operations.

Our midwestern customers are eager to receive Oklahoma gas. The supplies are abundant and secure, but the pipelines are willfully denying Hadson transportation services.

Hadson opposes the two blatant ploys being tried by interstate pipelines to evade their moral and commercial responsibility to America to provide fair, just, and reasonable long-distance gas transportation. These are two ploys: First, filing for 7(c) certificates. And, second, trying to introduce mandatory contract carriage legislation.

Hadson will intervene vigorously at the FERC to oppose 7(c) certificates. You are aware, Senator, that we have formed an alliance, not nationally with our ideological friends, but our companions in war, the Maryland People's Council and Michigan Consolidated, to uniformly and systematically oppose all 7(c) filings.

These 7(c) certificates, for those of you who do not necessarily live with them every day, permit specific end users to receive gas from specific and presumably favored suppliers, in particular the marketing affiliates of pipelines known as shadow pipelines.

We believe that 7(c) certificates are both inherently discriminatory and are a transparent device to circumvent open access transportation and thus subvert the whole principle of competitive gas transportation.

These certificates, Senator, we submit, are part of the problem. They are not a part of the solution. They perpetuate the old regime of willful discrimination, favoritism, and moving gas to those who are prepared to stay quiet and not speak up for free enterprise.

Hadson does not currently favor a legislative solution to the problems created by interstate pipelines. We believe contract carriage legislation stands no realistic chance of passing the House and Senate, despite the strong leadership I am sure that you would exert should you choose to pursue this legislation.

Protracted squabbling in the House and Senate will cause confusion, strife, and turmoil within the gas industry. The resulting paralysis will only serve to perpetuate the economic tyranny of the pipelines.

In blaming the FERC and in laying a legislative trap for Congress, the pipelines are furiously attempting to shift the focus of public indignation away from themselves.

In claiming that the fault lies not with them, but with FERC and Congress, pipelines are guilty of waging a disinformation campaign. It is not FERC or Congress that is not transporting gas, Senator, but the pipelines.

It is not FERC or Congress that is driving the Oklahoma independent into bankruptcy, but it is the pipelines.

It is not FERC or Congress that is causing the prices of gas to shoot up dramatically to the steel industry, the glass industry, and the testile industry; it is the pipelines.

The pipelines, obviously, are not followers of Abraham Lincoln and believe that you can fool all the people all the time. We, however, do believe in Lincoln, who said that those who would deny freedom to others deserve it not for themselves and cannot long retain it.

Interstate pipelines who claim that open access will exacerbate their take-or-pay probiems are being disingenuous. In fact, open access will alleviate the take-or-pay problem. Gas producers are willing to provide pipelines take-or-pay relief on volumes of gas released by the pipeline and transported to direct sales customers.

Moreover, in return for open access, producers are often willing to negotiate lower prices for system supply sales to interstate pipelines. In 1985, I believe the record will show that many pipelines, including Panhandle Eastern, enjoyed substantial take-or-pay relief for released gas that was transported for end users and local gas distribution companies.

Columbia Gas has recently demonstrated convincingly that producers and pipelines can renegotiate contracts to make prices more market sensitive and thus substantially alleviate the take-or-pay problems.

The take-or-pay problem is exaggerated.

If block billing and take or pay are the only issues keeping the pipelines from accepting order 436, then, Senator, why have the vast majority of pipelines not accepted nondiscriminatory transportation during the 45-day grace period between November 1 and December 14, when they are not subject to either the contract reduction problems that they say are major or block billing?

I think the answer has to be because they were monopolists yesterday, and they are monopolists today, and they want to be monopolists tomorrow.

To help bring the benefits of competition and free enterprise to the gas industry, Hadson requests you, Senator, to take three actions.

One, encourage the FERC to act forcefully in disciplining rogue pipelines. The FERC has yet to spell out what it intends to do to the pipelines that do not transport. There has been a lot of thunder and lightning from them in issuing the FERC order, but nothing about the consequences of defiance.

We urge you, Senator, to encourage the U.S. Attorney General to institute an antitrust investigation of monopolistic pipelines.

We also urge you to prompt the Federal Trade Commission, to, one, forbid further mergers by pipelines unless the merging pipelines agree to open access transportation. In the past the FTC has been approving these mergers, assuming there is no impact on competition. That is obviously not the case any more.

And we would request that the FTC at least study the option of forcing the recently created super pipelines to demerge if these pipelines continue to tyrannize the gas industry.

Hadson recommends that the FERC take the following three actions during pipeline rate cases:

One, eliminate from the rate base of an offending interstate pipeline that portion of pipeline capacity that is unused by willful management refusal to transport third-party gas.

Current FERC policy rewards pipelines for keeping their systems half empty and penalizes ratepayers by allowing a return on investment on underused facilities.

The managements of pipelines that deliberately underuse their facilities by refusing to transport third-party gas must at least be made to pay for their defiance of the FERC, and the free market, and their flagrant violations of their legal duties to both shareholders and ratepayers.

Second, the FERC should remove all minimum bill restrictions, including collection of nongas costs from contracts between interstate pipelines and LDC's, if the interstate pipeline refuses to accept open access.

Finally, the FERC should deny passthrough to ratepayers of cash settlements by interstate pipelines to buy out their TOP liabilities, that is, their take-or-pay liabilities, if the pipeline refuses to transport released gas.

I would submit, Senator, that pipelines who refuse to transport gas make the Grinch who stole Christmas look like Santa Claus.

Thank you.

[The prepared statement of Mr. Dar follows:]

STATEMENT OF VINOD K. DAR, PRESIDENT, HADSON GAS SYSTEMS, AT THE TULSA HEARING CALLED BY SENATOR NICKLES

(Scheduled for release on November 27, 1985 in Tulsa,
this Statement is in support of open access
gas transportation)

Hadson (consisting of Hadson Petroleum Corporation, Hadson Petroleum International, and Hadson Gas Systems) is an independent, publicly traded, company based in Oklahoma City, active in domestic and international oil exploration, domestic oil and gas production, and gas gathering and gas marketing. Hadson Gas Systems owns and operates 9 gas gathering systems and, as of November 15, had 56 direct sales contracts with industrial gas users and local gas distribution companies.

Hadson Gas Systems enthusiastically endorses the Federal Energy Regulatory Commission's effort to foster a competitive gas industry. FERC's move will bring to millions of gas consumers around the nation the benefits of competition and afford to hundreds of entrepreneurial gas producers, gatherers, and marketers, the business opportunities inherent in a free, competitive, and fair gas market. FERC correctly recognizes that the key to competition in the gas industry is fair and just long distance gas transportation by interstate pipelines.

The gross abuse of monopoly power by interstate pipelines who are denying transportation is having a devastating impact on the Oklahoma independent. As a consequence of the economic terrorism practiced by interstate pipelines, Hadson Gas Systems is moving about 100 MMCfd less of

Oklahoma gas to its customers than it otherwise would. Our Midwestern customers are eager to receive Oklahoma gas and the supplies are abundant and secure, but the pipelines are wilfully denying Hadson transportation services.

Hadson opposes the two blatant ploys being tried by pipelines to evade their moral and commercial obligation to provide America with fair, just, and reasonable long distance gas transportation. These ploys are (i) filing for 7(c) certificates and (ii) trying to introduce mandatory contract carriage legislation.

Hadson will intervene vigorously at the FERC to oppose 7(c) certificates. These certificates permit specific end users to receive gas from specific and, presumably, favored suppliers (in particular, the marketing affiliates of interstate pipelines known as shadow pipelines). We strongly believe that 7(c) certificates are both inherently discriminatory and a transparent device to circumvent open access transportation and thus subvert and sabotage the gas industry. These certificates are part of the problem, not part of the solution.

Hadson does not, currently, favor a legislative solution to the problems created by interstate pipeline. We believe contract carriage legislation stands no realistic chance of passing the House and Senate. Protracted legislative squabbling will, however, cause confusion, strife, and turmoil within the gas industry. The resulting paralysis will only serve to perpetuate the economic tyranny of the pipelines.

In blaming the FERC and in laying a legislative trap for Congress, the pipelines are furiously attempting to shift the focus of public indignation away from themselves. In claiming that the fault lies not with them, but with the FERC and Congress, pipelines are guilty of waging a disinformation campaign that could do the KGB proud. The pipelines obviously are not followers of Abraham Lincoln and believe that you can fool all the people all the time. We, however, do believe in Lincoln, who said that those who would deny freedom to others deserve it not themselves and cannot long retain it.

Interstate pipelines who claim that open access will exacerbate their take-or-pay (TOP) problems are being disingenuous in the extreme. In fact, open access will alleviate the TOP problem. Gas producers are willing to provide pipelines TOP relief on volumes of gas released by the pipeline and transported to direct sale customers. Moreover, in return for open access, producers are willing to negotiate lower prices for system supply sales to interstate pipelines. In 1985, Panhandle Eastern, for instance, enjoyed substantial TOP relief on "released" gas transported for end users and LDCs. Columbia Gas has recently demonstrated convincingly that producers and pipelines can renegotiate contracts to make prices more market sensitive and thus substantially alleviate TOP problems.

If block billing and TOP are the issues keeping pipelines from accepting Order 436, then why have the vast majority of pipelines not elected to be nondiscriminatory transporters during the 45 day grace period between November 1 - December 14 when they are not subject to either the block billing or the contract reduction provisions of Order 436?

To help bring the benefits of competition and free enterprise to the natural gas industry, Hadson respectfully requests Senator Nickles to:

(a) encourage the FERC to act forcefully in disciplining rogue pipelines

(b) urge the U. S. Attorney General to institute an antitrust investigation of monopolistic pipelines

(c) prompt the Federal Trade Commission to (i) forbid further mergers by pipelines unless the merging pipelines agree to open access transportation and (ii) force the recently created Superpipelines to demerge if these pipelines continue to tyrannize the gas industry.

Hadson recommends that the FERC take the following 3 actions during pipeline rate cases:

1. Eliminate from the rate base of an offending interstate pipeline that portion of pipeline capacity which is unused by willful management refusal to transport third party gas. Current FERC policy rewards pipelines for keeping their systems half empty, and penalizes rate payers by allowing a return on investment on under-used facilities. The managements of pipelines that deliberately under-use their facilities by refusing to transport third party gas must be made to pay for their defiance of the FERC and the free market, and their

flagrant violation of their legal duties to shareholders and ratepayers.

2. Remove all minimum bill restrictions, including collection of non-gas costs, from contracts between interstate pipelines and LDCs, if the interstate pipeline refuses to accept open access.

3. Deny pass through to rate payers of cash settlements made by interstate pipelines to buy out their TOP liabilities if the pipeline refuses to transport "released" gas.

Senator **Nickles**. I do not think you like the pipelines very much. [Laughter.]

I have several questions for the panel.

I will open this up to most any of our panelists, and, Mr. Dar, I do appreciate your suggestions. I will ask some of the other panelists. Mr. House, you mentioned a couple of suggestions.

First, I want to touch on trying to define the amount of the problem. I think we heard from the Oklahoma Corporation Commission they estimate that we had 300 million cubic feet of gas shut in per day. We have been trying to get these figures.

One of the reasons why we wanted to have the hearing today was maybe see if we could not make further progress.

Mr. Dar, you mentioned your company alone had 100 million cubic feet of gas shut in per day——

Mr. **Dar**. Yes.

Senator **Nickles** [continuing]. As a result of that order.

Have you been able to reduce that amount or is that still the amount of gas that you have shut in per day?

Mr. **Dar**. We have been able to switch to Louisiana, but it does not do much for the Oklahoma producers.

Senator **Nickles**. But Oklahoma gas, you have 100 million cubic feet?

Mr. **Dar**. Yes.

Senator **Nickles**. Mr. Whitworth, did you give me a statement on how much you——

Mr. **Whitworth**. I gave you a figure, Senator, of 160 million, approximately.

Senator **Nickles**. Per day?

Mr. **Whitworth**. Per day.

Senator **Nickles**. Mr. Davis, did you have a figure?

Mr. **Davis**. I did not give you a figure, but it is about 70 million a day, but it is not all in Oklahoma. I cannot tell you exactly how much of it is in Oklahoma. That is our overall system.

Senator **Nickles**. Conoco-wide, you have 70 million?

Mr. Whitworth, was yours Oklahoma-wide or companywide?

Mr. **Whitworth**. That is Oklahoma production.

Senator **Nickles**. Oklahoma production?

Mr. **Whitworth**. Yes.

Senator **Nickles**. Mr. Graves and Mr. House, do you have any feeling, either in your companies or other independents, what percentage or what volumes of gas might be shut in, because the figures, we are already 100 and 160. So the 300 million cubic feet is evidently quite low. It evidently must be much higher than that.

I am talking about gas that was moving in the spot market prior to November 1 that is not moving today.

Mr. **Dar**. We are talking about gas that was under contract, sold to an end user and scheduled to move after FERC passed its order.

Senator **Nickles**. OK.

Mr. **Dar**. That gas is not moving and, as far as we know, it is not going anywhere.

Senator **Nickles**. Let me try and figure out how much there is. I have got 100 and 100 and how much, 160 from——

Mr. **Whitworth**. Let me clarify that, Senator, because the 160 figure is that which is shut in today, plus that which we are anticipating is going to be shut in, based on conversations with the pipelines.

Senator NICKLES. OK; so now you are past December 15?

Mr. WHITWORTH. It will occur before December 15.

Senator NICKLES. Any other quesstimates or anything?

Mr. GRAVES. We do not have the figures. As I said, our producers are very reluctant to admit to this possibility.

Senator NICKLES. But it is obvious that 300 million cubic feet per day is on the short side. We have that almost at this table and you have 1,500 independent producers; 1,498 of them are not here.

Mr. DAR. Senator, I would clarify that because Hadson Gas Systems has extensive gathering systems, all the shut-in gas is not Hadson Petroleum's, but also that of the independents who are tied behind us.

Senator NICKLES. OK; I appreciate your distinction.

Mr. DAR. I would say perhaps as many as 25 or 30 independents are affected by this, whose gas is tied to our systems or who sell to——

Senator NICKLES. Tied to you?

Mr. DAR. Yes; so it is not just——

Senator NICKLES. I appreciate your comment, but it still shows that the ramification of it, and we might discuss this with some of the pipelines, try to get some indication of how big the problem is presently. I think that might help us better understand the solutions.

Speaking of the solutions and dealing strictly with transportation, Mr. House, you made some, what I consider, very good suggestions on how we get past this interim period and I will concur with that.

I will announce to the group something that we are working on that is my intention when we return to Washington, DC, that I do plan on filing a petition before the Commission which calls on them to take several actions.

I will just touch on those briefly.

One, I am going to urge the Commission to extend the transportation program's transitional period to April 15, 1986, in lieu of the current December 15 period expiration date.

This gives the Commission time that it needs to work some of the bugs out of the program and, hopefully, give pipelines a chance to examine—because, as Mr. House mentioned, we are talking about substantial changes for pipelines in their method of operations.

Second, I will also be calling upon the Commission to eliminate those provisions of the transportation program which abrogate contracts.

As I have mentioned many, many times, I do not think the FERC is allowed by the wand of a rule to cause massive abrogation. I also have serious reservations about Congress doing that as well.

And, third, I am going to call upon the Commission to review its program from stem to stern and try and find and eliminate any disincentives for pipelines to participate.

Quite frankly, both of those are tied together and I think the 25-percent contract demand reduction is basically saying that, yes, end users could abrogate significant portions of contracts does lead to increased take-or-pay exposure and liabilities which scare and cause many pipelines that might be willing to participate to back off from participation.

Mr. **House**. Senator, I would just like to talk for 1 second on my comments earlier. I think that a lot of the producer-pipeline contracts have already been abrogated.

Senator **Nickles**. You are correct.

Mr. **House**. It is fine to say we cannot abrogate one without the other. I think we have already abrogated the other and I do not know that they are being consistent in their analysis.

Senator **Nickles**. Well, a lot of that abrogation, a lot of it has been renegotiation and a lot of the renegotiation, in this Senator's opinion, has been very positive because it has helped bring us into a market—closer to a market apparatus.

But I can also see the concerns and the possible litigation that could go forward if you allow end users by, again, a stroke of a rule, to have abrogation. Then you are going to have litigation that is going to be forced upon pipelines and producers.

I do not see that as being healthy. I do not see litigation as being overly healthy.

One final point. I am going to be calling upon the Commission to provide an interim gas transportation program that will enable gas to be transported during the ongoing winter heating season. Hopefully, this will continue, whether they are using 7(c) or whether they are using 311, or whatever else.

I think it is important that we keep gas moving during this heating season, keep gas flowing out of the State of Oklahoma, regardless of what sections.

I hope that is the case, that we can get past it.

Are there other changes, in your opinion, that could or should be made in the transportation provisions in order to entice pipelines to participate?

Mr. **Dar**. Senator, you are opposed and the pipelines are opposed to the 25-percent reduction.

Would you also be opposed to a negotiated amount which individual local distribution companies sit down with individual pipelines and agree upon some negotiated contract demand number?

Now, this has happened during rate settlements. The customers of supplied plants have sat down with pipelines and agreed to reduce their contract demand by some percent, whether it is 3 percent or 15 percent. In the case of Columbia, it is a much bigger number.

That seems to me gets to where the FERC wants to go, but it leaves the negotiating and the specifics in the hands of individual private parties.

Senator **Nickles**. This Senator has always been in favor of trying to encourage voluntary negotiations by both parties.

I would also say, too, in that contract demand reduction and the take or pay that has been mentioned, some of those have already been done. I think all of our producing panelists have mentioned that a lot of those changes have already been made.

A lot of those have been made in exchange for access and we will have the pipeline panel and I am sure that they are going to say that. Basically, if you give the access, you may have taken away some of their leverage. That is one of their bargaining tools.

I am just trying to say that I think it is important that we see all sides and not necessarily pit producers versus pipelines. That is not healthy for the industry.

I think it is healthy for the industry to resolve these problems, get this gas moving and I think that is healthy for consumers as well.

So, a couple of things:

One, any changes that members feel on the panel that should be made in the transportation rule that would encourage pipelines to participate?

Mr. Davis, do you have a comment?

Mr. DAVIS. I guess just an overall statement that I think if the economic incentives for the pipelines to participate are there, they will do it. I think they view the 25-percent problem as a significant problem to them. I am sure they think they ought to be able to lower some of the higher priced contracts.

Again, I think we have done very well negotiating one-on-one in the past with these various companies. As much individual negotiation between the two parties that you can have and the quid pro quo that each party gets is healthy for the industry.

So, I think the more open and one-on-one negotiations we have, the better off we are. I think that the pipelines are in business and they need to be in business to make a profit, just like we all do. And if they are given the opportunity to do so, I think they will.

I do not think 436, as it is now structured in the transportation mode, gives them that opportunity.

Senator NICKLES. Mr. House.

Mr. HOUSE. Senator, the issues are very complex when you go down and try to work out a nuts and bolts solution, but to the extent that any pipeline company loses an LDC customer, if a mechanism was in place where that LDC customer would go to that pipeline's producers first to try to replace that gas, the pipeline would obviously receive take-or-pay relief to the extent that such gas flowed through the pipeline to that LDC customer.

I do not think any producer has ever asked for, or at least has not received, the ability to transport without commensurate take-or-pay relief. I think that might be very tricky to bring that to fruition because there is no guarantee that the producers connected to that pipeline would be willing to do business with an LDC, but at least the LDC would go to that pipeline's producers first.

Senator NICKLES. Let me kind of restate that in a different way.

In other words, then, if a pipeline—not so much as blanket access, but if they granted access to a particular producer, that for that volume of gas, that producer would have to waive his take or pay, or the pipeline's take-or-pay responsibility for that volume of gas?

Mr. HOUSE. I am not aware of all situations, certainly, but in the majority of situations, I am aware of when the pipeline receiver released to sell direct, that was a total release from contract and that involved releasing the take-or-pay obligations that the pipeline had for that gas.

Senator NICKLES. For that specific amount of gas. Some pipeline proposals—I think Mr. Dar alluded to it. I am going to get your attention on this because I think you may be the one that answers it.

One of the pipeline proposals before our committee last week was basically along the line of, yes, we would take carriage if also we had take-or-pay relief. They made it more broadsweeping; I think, as originally defined, it meant just gas for gas. They were talking like, yes, if we could get out of all of our take or pay, we would take open access.

I was thinking maybe more of a contract per contract. If we were taking access on this amount of gas, they would also be relieved of a corresponding number of take-or-pay reduction.

Is that along the lines that you were thinking about?

Mr. House. Yes, sir. That is exactly what I am saying. I would not favor just a blanket abrogation of contracts, but rather a voluntary program in which—you know, independent producers are in such unique situations. Every one of them has a different cash flow need level. Some are very high and some are not so high.

I think there are a lot of independents out there that would willingly enter a program that would trade any obligation on the take-or-pay side for access.

Senator Nickles. One other comment and we will have the pipeline people up in just a moment, but the other thing I was hearing in our hearing last week in Washington, DC, from the pipeline people was somewhat of a fear that if access was allowed, blanket access, nondiscriminatory access, to where anyone could come in, that, yes, they would still have some of these contracts, but basically it would be, I guess, where they might have a contract buying gas from Jack Graves for $3.50 and somebody else was going to come in and supply that same gas to that LDC, say, for $2 and they might still be stuck with that liability with Jack Graves, although somebody else's take-or-pay liability on that contract, whereas another person came in and supplied that gas.

You just allowed that LDC to abrogate their contract, but they are still stuck with your liabilities.

The scenario I painted just a minute ago is if you had the same producer supplying that same amount, but that is not what you would have in most cases.

You would find a different producer going around supplying that gas, taking away "the pipeline's former customer" and leaving the pipeline with a take-or-pay liability to you and gas that they could no longer take.

Any comment on that?

Mr. House. Yes; I think that the combination of—theoretically, that could happen, but the combination of people that have already given significant take-or-pay relief, plus the addition of people that would accept or trade access for take-or-pay relief, I doubt that it would become that significant.

Most pipelines are going to retain certain customers that do not have switching capabilities, either to fuels or to other pipelines. Most pipelines are going to continue to have a baseload of residential customers, for instance, that do not have a lot of options available to them.

That would be my thought on that.

Senator Nickles. But that group of customers, that LDC, would still have the right to abrogate. They would have a right to abrogate that contract with Panhandle Eastern for $3.50 that they are paying Jack Graves for, say, and then they could come in and buy from Samson for $2 to fill that contract.

So, they are getting the gas. They are getting the better deal for "customers," but they just have a take-or-pay liability problem that they are not going to be able to take with their former customer.

Mr. HOUSE. Right. I am saying there are so few Mr. Graveses in the world that the volumes would be insignificant. [Laughter.]

Senator NICKLES. I will not touch that.

Mr. DAR. Excuse me, Senator.

Senator NICKLES. Yes.

Mr. DAR. You talk about incentives. I think there are maybe a couple of areas that the FERC has not considered.

It seems that right now the pipelines get to keep too little of the revenues from transportation, and maybe if the FERC let them keep some more of their transportation revenues, they would have a better incentive to transport gas.

And, second, I do not see why the FERC should have a ceiling on the amount on the rate of return the pipelines can make. If a pipeline goes out and is competitive and makes money, it should be allowed to keep it.

Senator NICKLES. What was your first comment?

Mr. DAR. The first comment, Senator, is, I think the pipeline should be allowed to retain more of their transportation revenue than they currently are allowed to retain as a profit. They have to pass on much of the benefits of their transportation revenues to their firm customers.

I think in certain instances they only get to keep a penny as profit. That is too little.

Senator NICKLES. I appreciate your comments. All of our panelists—we thank you very much for your participation.

Mr. GRAVES. Senator, just keep on doing what you are doing. We appreciate everything you do.

Senator NICKLES. Thank you very much.

Our next panel, if they would all come forward, please.

Keith Bailey.

To all of our panelists, we appreciate your patience and are also glad that you can see that we have some interest in this legislation proposal.

Mr. Bailey is president of Northwest Ceneral Pipeline, Tulsa, OK.

Mr. Bailey, please proceed.

STATEMENT OF KEITH E. BAILEY, PRESIDENT, NORTHWEST CENTRAL PIPELINE CORP.

Mr. BAILEY. Mr. Chairman, I would also point out for the record, because I think it has some bearing on comments that I am going to make, that I am also chairman of the board of Williams Pipeline and both Williams Pipeline and Northwest Central are subsidiaries of the Williams Cos., headquartered in Tulsa, OK.

Like the other commenters, I appreciate the opportunity to present my views and those of the Williams Cos. on the issue of FERC order 436 and, in particular, that part of the order that deals with transportation.

And also like the other commenters, I want to commend you and this committee for your efforts in looking beyond the rhetoric to seek the facts upon which constructive solutions to our mutual concerns can be based.

Williams and its two interstate pipeline subsidiaries, Northwest Pipeline and Northwest Central Pipeline, have participated in all phases of the development of the final order.

In addition, Mr. Vernon Jones, who is president of the Williams Cos., testified in previous hearings before this committee in September.

Throughout that process, we have consistently supported the concept of expanded access to pipeline transportation, so long as that access is achieved in a manner that recognizes the realities of the current relationships that exist among the various sectors of the industry as a result of our long history of regulatory standards and so long as that transportation access is achieved in a manner that deals with those existing relationships in a way and on a timetable that is fair to all sectors.

I mentioned my relationship with Williams Pipeline before because the Williams Cos., through Williams Pipeline, has had a long history of participation in the oil pipeline business. The oil pipeline business, as you know, is a common carrier transportation business, and it is an industry in which I personally have worked since 1962.

I, certainly, and we, as a company, have no philosophical aversion to open access, nondiscriminatory pipeline transportation and, in fact, value that as a business line. But because of our experience, we also know what it takes to create the environment that is necessary for it to work and work well.

In our judgment, order 436 clearly does not create such an environment and the proposed block billing feature simply exacerbates the problem.

Now, before I deal specifically with some of the shortcomings we see in order 436, I also want to respond to some of the general criticisms of our industry which have surfaced in recent days.

The first observation I would make is that the bulk of the criticism and much of what you have heard today has been generated by producers and consumers for which pipelines were providing transportation under the existing regulatory scheme.

The pipelines did not suddenly decide to go out of the transportation business. In fact, I think a fair assessment of the growth of transportation and spot gas transactions over the past 24 months leading up to November 1 will demonstrate that our industry was making a very rapid transition to transportation services under the existing rules.

In formulating order 436, the FERC had the express objective of making pipelines financially indifferent as to whether they provided the traditional merchant function of buying and selling gas, or whether they simply provided transportation services.

The level of pipeline transportation that existed prior to November 1 was the result of pipelines pursuing reasonable economic objectives within the existing regulatory framework.

The reduction in such services on November 1, to the extent that such reduction occurred, was a direct result of the failure of order

436 to foster the economic indifference the Commission itself recognized as being an essential element of an open access transportation policy.

The response of Williams' two pipeline subsidiaries is very illustrative of that point. Northwest Pipeline elected to continue open access transportation for at least the initial 45-day period. Northwest Central elected not to do so.

This was not a case of corporate schizophrenia. It was a matter of two completely rational decisions in light of two very different factual situations. Earlier in 1985, Northwest Pipeline, as part of a rate case settlement, achieved the end result of formulating an open access transportation tariff, which did allow Northwest to aggressively pursue transportation opportunities and which expanded the market demand for gas in the Pacific Northwest.

The rate settlement provided for costs on Northwest's system to be allocated on sales and transportation volumes, providing Northwest with an incentive to enhance the utilization of its system, and it is currently considering the advisability of continuing such a policy beyond December 14.

On the other hand, Northwest Central Pipeline has an existing transportation tariff which was put in place as part of its settlement of a 1982 rate case which has the basic objective of increasing its system utilization.

Unlike Northwest's tariff, however, Northwest Central's requires essentially all transportation revenues in excess of the incremental operating costs of providing the service to be credited back to our sales customers.

As a result, we clearly cannot be indifferent to an open transportation program which would allow our income sources to be converted to nonincome sources on a one-for-one basis.

Fortunately for our producers and transportation customers, virtually all of our existing transportation agreements were the type that were grandfathered under order 436, so there was a minimum disruption of service resulting from our decision not to become an open access transporter by November 1.

Order 436 is an effort to completely restructure the transitional relationships that have existed in our industry for an extended period of time. Simply stated, those relationships were ones based on the principle of matching specific markets to specific sources of supply in ways which were intended to maintain a reasonable balance over time.

Order 436 disrupts these balances in a way which leaves the pipeline sector extremely vulnerable to significant financial penalties with little, if any, offsetting opportunity for financial success.

First, the order confers a unilateral right upon the pipeline's customers to restructure their purchase obligations. The unilateral nature of that right completely strips the pipeline of any ability to negotiate terms and conditions that would accomplish that restructuring in a way which would be fair to both parties.

Similarly, on the producing end of the pipeline, the Commission's rule would confer on the producers the ability to seek abandonment should they suffer substantially reduced takes. This is done while the rule at the same time strips the pipeline of a negotiating tool, which you referred to earlier, which is essential to the balancing of producer and pipeline interests.

The willingness of pipelines to include take-or-pay or similar provisions in their gas purchase contracts was clearly predicted on the assumption that they would have the ability to match production to markets. By allowing producers and customers unilaterally to change contract terms, without regard to the impact on the supply/demand balance on the pipeline, leaves pipelines in an untenable position.

As a minimum, we would suggest that fairness and equity would dictate that the mechanism for modifying contractual relationships on either end of the pipeline be restored to a bilateral process and that the pipeline be provided a realistic opportunity to maintain a balance between its sources of supply and its markets.

I would point out again that even though it is far from perfect, the existing system of regulation has permitted a great deal of restructuring of contract relationships to take place and take place at both ends of the pipeline and it has done so with the historic balancing of interests of all of the parties remaining a key criteria.

In closing, I want to cite again our own company as one example of what can be accomplished under the existing regulatory structure. In 1983, Northwest Central's weighted average cost of gas had risen to $3.10 per 1,000 cubic feet and it was in danger of losing significant markets.

It established a target price program which altered purchase practices to ensure that it achieved market-sensitive prices. That, in turn, immediately caused an exposure to hundreds of millions of dollars in take-or-pay liability.

Since that time we have negotiated successfully with our producers and pipeline suppliers to the point that we are currently experiencing no net take or pay and, in fact, are making up some of the relatively modest levels which were incurred in prior years.

We have also reduced our weighted average cost of gas to approximately $2.08 per 1,000 cubic feet, a level which is equivalent to those being experienced in the 30-day spot market.

At the same time we instituted the transportation tariffs I discussed earlier as part of our 1982 rate case settlement and have gone from effectively no transportation prior to that time to an expectation of in excess of 50 billion cubic feet of transportation gas during 1985 and this will represent some 15 percent of our total anticipated volume for the year.

Likewise, Northwest Pipeline has made steady progress in reducing its gas costs while minimizing actual take-or-pay exposure. It, too, has greatly expanded its transportation services through the open access transportation tariff it put in place as part of its 1985 rate case settlement.

These significant levels of transportation for both companies have been achieved through settlement negotiations under existing regulatory standards and on terms which are mutually beneficial to producers, customers, and the pipelines.

We have accomplished all of this while maintaining the kind of balance between the pipeline, the producers, and the customers that is essential if this industry is to remain healthy over time. We have also done so while maintaining the two highest reserve life indexes in the interstate pipeline industry.

Competitive gas prices, long-term supply security, transportation options for producers and customers, and financial exposure of the pipeline and its customers to take-or-pay liability are, as you have heard earlier, all complex and largely interdependent concerns and these are concerns that Williams and its two pipeline subsidiaries have been able to address successfully through negotiation with individual customers and individual producers.

Order 436 has the very real potential, if not probability, of wiping out all of the gains that we have made. It is a step backward that penalizes most those companies which have most successfully dealt with the problems facing the industry under current regulatory limits.

It seems to me that the fundamental question before Congress today is whether it wants to endorse the FERC's grand experiment with its demonstrated problems in the hope that somehow it will prove superior to the historic regulatory practices, or whether the Congress would prefer that FERC seek ways to simply modify those historic practices to facilitate an easier transition in an evolution that is already well underway in the industry.

If, as I submit it should be, the answer is the latter, in our judgment, it is likely Congress will have to intervene in the process, as it appears that the FERC is irrevocably committed to the former course of action.

Before I close, I would like to respond specifically to three points that were raised by prior presenters. I would caution as we move forward in trying to discuss the impacts of the decisions of the interstate pipeline industry to provide transportation, that we attempt to define that impact on a net basis.

My own sense is that to date there has been little net change in total gas movements, as in most cases contract gas has been substituted for transportation gas.

Clearly, as the other presenters have pointed out, there have been dramatic shifts as to whose gas was moving. We cannot deny the individual hardship that is created.

Transportation gas that is no longer moving is easy to identify. Hard to identify are additional sales gas being taken as a result of the cessation of transportation. One of the reasons it is difficult is because all of this is occurring at a time when we are moving into the winter heating season and additional sales would be expected to take place in any event.

I think it is going to be some 60 to 90 days until accurate data is received and until then and until we factor in the impact of this year's weather as opposed to prior years, before we can really intelligently analyze the net impact that it has had on the State of Oklahoma or the gas industry generally.

The second observation I would make is that some, but not all, of the take-or-pay clauses that are included in gas purchase contracts include the type of provision Mr. Davis discussed earlier where in the event that the take or pay is not made up within a specified time period, that any remaining balance is refunded to the pipeline.

Again, I think this points out the need to continue to move forward in a series of individual negotiations because it is difficult to find a coat that will fit all parties.

The other thing that I would point out is that many, but again not all, of the producers have renegotiated contracts and I think those negotiations are moving forward and good progress is being made.

The final observation I would make in regard to the prior comments, in my judgment, block billing, which I did not refer to in any great depth in my prepared statement, will accelerate the short-term decline in gas prices, and that acceleration will, in turn, pull forward the point in time at which we are once again in a supply/demand balance or even a shortage.

Traditional regulation has and I think will continue to act as a shock absorber and will ultimately result in less severe declines in gas prices and a less dramatic transition from the supply surplus that we currently face to either a supply balance or a supply shortage.

At the time when many were more interested in name calling that in ensuring that the previously existing transportation is continued, you, Senator, and members of your committee have identified problems that have caused gas transportation to be terminated.

Like others, we would like to commend you and the other Senators that assisted in sponsoring Senate Resolution 255 because with that we feel you have sought to have the FERC correct the many flaws that resulted in reduced gas transportation, when its stated goal, and a good goal, was to increase transportation.

I think in doing so you have also recognized that the interests of each segment of the wellhead to burner tip distribution chain must be treated in an even-handed manner if any of the segments is to remain financially viable over time.

We look forward to working with you, the producers, the consumers, and others to assure a practical, fair, efficient, and economical transportation program for everyone's benefit.

In fact, in spite of some of Mr. Dar's colorful characterization of our industry, I find that in listening to the producers, that we have many views in common, and we have differences. I am optimistic because of that that we are going to be able to find practical solutions that do address the problems.

I appreciate the opportunity to present my views and would be happy to respond to any questions that you may have later.

[The prepared statement of Mr. Bailey follows:]

TESTIMONY OF
KEITH E. BAILEY
PRESIDENT
NORTHWEST CENTRAL PIPELINE CORPORATION

BEFORE THE SENATE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES

NOVEMBER 27, 1985
TULSA, OKLAHOMA

MR. CHAIRMAN, MY NAME IS KEITH BAILEY, AND I AM PRESIDENT OF NORTHWEST CENTRAL PIPELINE CORPORATION AND CHAIRMAN OF THE BOARD OF WILLIAMS PIPE LINE COMPANY, BOTH SUBSIDIARIES OF THE WILLIAMS COMPANIES, HEADQUARTERED IN TULSA, OKLAHOMA. I APPRECIATE THE OPPORTUNITY TO PRESENT MY VIEWS AND THOSE OF THE WILLIAMS COMPANIES ON THE ISSUE OF FERC ORDER 436 AND IN PARTICULAR THAT PART OF THE ORDER THAT DEALS WITH TRANSPORTATION. I WANT TO COMMEND YOU AND THIS COMMITTEE FOR YOUR EFFORTS IN LOOKING BEYOND THE RHETORIC TO SEEK THE FACTS UPON WHICH CONSTRUCTIVE SOLUTIONS TO OUR MUTUAL CONCERNS CAN BE BASED.

WILLIAMS AND ITS TWO INTERSTATE PIPELINE SUBSIDIARIES, NORTHWEST PIPELINE CORPORATION AND NORTHWEST CENTRAL PIPELINE CORPORATION, HAVE PARTICIPATED IN ALL PHASES OF THE DEVELOPMENT OF THE FINAL ORDER. IN ADDITION, MR. V. T. JONES, PRESIDENT OF THE WILLIAMS COMPANIES, TESTIFIED IN HEARINGS BEFORE THIS COMMITTEE ON SEPTEMBER 19 OF THIS YEAR. THROUGHOUT THAT PROCESS, WE HAVE CONSISTENTLY SUPPORTED THE CONCEPT OF EXPANDED ACCESS TO PIPELINE TRANSPORTATION SO LONG AS THAT ACCESS IS ACHIEVED IN A MANNER THAT RECOGNIZES THE REALITIES OF THE CURRENT RELATIONSHIPS THAT EXIST AMONG THE VARIOUS SECTORS OF THE INDUSTRY AS A RESULT OF OUR HISTORIC REGULATORY STANDARDS, AND SO LONG AS THAT TRANSPORTATION ACCESS IS ACHIEVED IN A MANNER THAT DEALS WITH THOSE EXISTING RELATIONSHIPS IN

A MANNER AND ON A TIMETABLE THAT IS FAIR TO ALL SECTORS. THE WILLIAMS COMPANIES HAS A LONG HISTORY OF PARTICIPATION IN THE OIL PIPELINE BUSINESS, A COMMON CARRIER TRANSPORTATION BUSINESS AND AN INDUSTRY IN WHICH I PERSONALLY HAVE WORKED SINCE 1962. WE HAVE NO PHILOSOPHICAL AVERSION TO OPEN ACCESS NON-DISCRIMINATORY PIPELINE TRANSPORTATION, BUT WE DO KNOW WHAT IT TAKES TO CREATE THE ENVIRONMENT NECESSARY FOR IT TO WORK AND WORK WELL. ORDER 436 CLEARLY DOES NOT CREATE SUCH AN ENVIRONMENT AND THE PROPOSED BLOCK BILLING FEATURE SIMPLY EXACERBATES THE PROBLEM.

BEFORE I DEAL WITH SOME OF THE SPECIFIC SHORTCOMINGS OF ORDER 436, I WANT TO RESPOND TO SOME GENERAL CRITICISMS OF THE INTERSTATE PIPELINE INDUSTRY WHICH HAVE SURFACED IN RECENT DAYS. MOST OF THESE CRITICISMS RESULT FROM THE FACT THAT TO DATE ONLY A LIMITED NUMBER OF PIPELINES HAVE ELECTED TO OFFER OPEN ACCESS TRANSPORTATION DURING THE 45 DAY PERIOD BETWEEN NOVEMBER 1 AND DECEMBER 15. THIS IS A TRANSITION PERIOD WHEN THEY COULD DO SO WITHOUT MAKING A DECISION TO OFFER SUCH TRANSPORTATION ACCESS ON A PERMANENT BASIS.

THE FIRST OBSERVATION I WOULD MAKE IS THAT THE BULK OF THIS CRITICISM HAS BEEN GENERATED BY PRODUCERS AND CONSUMERS FOR WHICH PIPELINES WERE PROVIDING TRANSPORTATION UNDER

THE EXISTING REGULATORY SCHEME. THE PIPELINES DID NOT SUDDENLY DECIDE TO GO OUT OF THE TRANSPORTATION BUSINESS. IN FACT, A FAIR ASSESSMENT OF THE GROWTH OF TRANSPORTATION AND SPOT GAS TRANSACTIONS OVER THE TWENTY-FOUR MONTHS LEADING UP TO NOVEMBER 1ST DEMONSTRATES THAT THE INDUSTRY WAS MAKING A VERY RAPID TRANSITION TO TRANSPORTATION SERVICES UNDER THE EXISTING RULES. A NOVEMBER STUDY RELEASED BY THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA (INGAA) SHOWS THAT BY THE SECOND QUARTER OF 1985, TRANSPORTATION BY INTERSTATE PIPELINES ON BEHALF OF DISTRIBUTORS AND END USERS HAD GROWN TO SOME 16% OF THE TOTAL MARKET AND WAS INCREASING RAPIDLY. I EXPECT THIRD QUARTER STATISTICS, WHEN THEY ARE AVAILABLE, TO SHOW AN EVEN HIGHER PERCENTAGE. THAT HARDLY SUGGESTS PIPELINES HAVE BEEN RECALCITRANT IN THEIR PARTICIPATION IN THESE MARKETS NOR DOES IT SUGGEST EXISTING REGULATORY PRACTICES ARE INADEQUATE TO ALLOW AN ORDERLY MARKET RESTRUCTURING. THE OBVIOUS QUESTION IS, WHY DO PIPELINES APPEAR UNWILLING TO EMBRACE THE TRANSPORTATION CONCEPTS EMBODIED IN ORDER 436 WHEN THE COMMISSION HAS STATED ITS INTENT TO MAKE THEM FINANCIALLY INDIFFERENT TO DOING SO?

IT SHOULD COME AS NO SURPRISE THAT PIPELINES MIGHT VIEW THE COMMISSION'S ASSERTIONS WITH A HEALTHY DEGREE OF

SKEPTICISM, PARTICULARLY WHEN ONE LOOKS AT THE DETAILS OF THE RATE SETTING METHODS THE COMMISSION PROPOSES TO UTILIZE TO ACHIEVE THESE OBJECTIVES.

IT APPEARS THAT THE COMMISSION IS TRYING TO SERVE TWO, SOMEWHAT INCOMPATIBLE, MASTERS IN THE METHOD THAT THEY DESCRIBE FOR TRANSPORTATION RATE SETTING. THEIR OVERRIDING CONCERN APPEARS TO BE TO AVOID CRITICISM FOR ALLOWING A PIPELINE TO "OVER ACHIEVE". AS A RESULT, THEY PROPOSE ESTABLISHING THE TOP OF A ZONE OF TRANSPORTATION RATES ON THE BASIS OF THE FULL PHYSICAL CAPACITY OF THE PIPELINE SYSTEM WITH THE LOWER END OF THE RATE ZONE SET BY THE PIPELINE'S INCREMENTAL COST TO PROVIDE THE SERVICE. THE PIPELINE WOULD BE ALLOWED TO ESTABLISH INDIVIDUAL TRANSPORTATION RATES WITHIN THAT ZONE AND THE COMMISSION CONCLUDES, THEREFORE, THAT NO TRANSPORTATION CUSTOMER WOULD PAY UNREASONABLE RATES AS THE HIGH END OF THE ZONE WOULD BE SET AT "JUST AND REASONABLE" LEVELS. BY THE SAME TOKEN, IT IS ALSO OBVIOUS THAT UNDER THIS METHOD, A PIPELINE HAS NO POTENTIAL TO EVER EXPERIENCE THE KIND OF SUPERIOR FINANCIAL PERFORMANCE THAT SHOULD ACCOMPANY THE INCREASED LEVEL OF BUSINESS RISK ASSOCIATED WITH THE VARIOUS PROVISIONS OF ORDER 436. THE MAXIMUM A PIPELINE COULD EVER ACHIEVE

UNDER THIS CONCEPT IS ITS BASE COST OF SERVICE, AND LOGIC WOULD DICTATE THAT IN MOST INSTANCES THE PIPELINE WOULD BE CONSIGNED TO RETURNS BELOW THAT LEVEL.

ANOTHER BASIS FOR THE PIPELINE SKEPTICISM REGARDING THE SO CALLED OPPORTUNITIES UNDER THE NEW RULE IS THE DEMONSTRATED INABILITY OF REGULATION TO DEAL WITH A RICH UNIVERSE OF FACTS. EVEN THOUGH THE ECONOMIC CONCEPTS WHICH UNDERLY THE ORDER REQUIRE FLEXIBLE AND DIVERSE MARKET RESPONSE CAPABILITIES IF THEY ARE TO HAVE THE END RESULT THE COMMISSION INTENDS, HISTORY SUGGESTS THAT THE FERC CANNOT OPERATE IN SUCH AN ENVIRONMENT. ACTUAL REGULATION INVOLVES THE TEDIOUS PROCESS OF FILINGS FOLLOWED BY REVIEW AND HEARINGS. AS ONE MOVES FORWARD IN TIME, FLEXIBILITY IS REDUCED TO A RAZOR'S EDGE THROUGH A SERIES OF INDIVIDUAL DECISIONS. THE COMMISSION BECOMES INCREASINGLY RIGID IN ITS APPLICATION OF REGULATORY "PRINCIPLES", AND INDIVIDUAL COMPANIES ARE FACED WITH COOKIE CUTTER TYPES OF DECISIONS IRRESPECTIVE OF THEIR PARTICULAR AND UNIQUE CIRCUMSTANCES. THAT IS EXACTLY THE KIND OF ENVIRONMENT THAT THE PIPELINE INDUSTRY HAS EVERY REASON TO EXPECT AS THE NEW RULES ARE APPLIED IN ACTUAL PRACTICE AND YET THAT KIND OF AN ENVIRONMENT IS THE ANTITHESIS OF THE TYPE NEEDED TO FOSTER THE DEGREE OF RESTRUCTURING CONTEMPLATED IN ORDER 436.

ANOTHER FEATURE THAT GENERATES SKEPTICISM IS THE APPARENT UNWILLINGNESS OF THE COMMISSION TO RECOGNIZE THE EVOLUTION THAT HAS ALREADY TAKEN PLACE IN THIS INDUSTRY. IT APPEARS THE NEW ORDER IS A CLASSIC CASE OF THROWING THE BABY OUT WITH THE BATH WATER. RATHER THAN CONSIDERING ALTERNATIVES WHICH USE EXISTING REGULATORY PRACTICES AS THEIR PREDICATE, THE COMMISSION STARTS WITH A BLANK SHEET OF PAPER. WHILE IGNORING THE REALITIES OF 44 YEARS OF REGULATORY HISTORY MAY BE THE EASIEST WAY TO ADVANCE A NEW ECONOMIC THEORY, IT CLEARLY LACKS PRACTICALITY, AND COMMON SENSE SUGGESTS IT WILL BE EXTREMELY DIFFICULT TO IMPLEMENT IN PRACTICE. AS I POINTED OUT EARLIER, THE INDUSTRY ALREADY HAS MADE TREMENDOUS STRIDES IN ACCOMMODATING SUCH PRACTICES AS TRANSPORTATION AND THE SPOT MARKETING OF GAS WHICH ARE DEMANDED IN TODAY'S SURPLUS MARKET.

THE OTHER CRITICISM THAT HAS BEEN LEVELED AT PIPELINES IS THAT THEY, IN SOME WAY, ARE USING THE RULE AS AN EXCUSE TO EXTRACT "MONOPOLIST" PROFITS BY REFUSING TRANSPORTATION. IT SHOULD ALWAYS BE REMEMBERED THAT WHATEVER INCOME A PIPELINE DERIVES FROM ITS JURISDICTIONAL BUSINESS IS DERIVED FROM RATES AND CHARGES ESTABLISHED IN ITS TARIFF. THOSE RATES AND CHARGES HAVE BEEN EXPOSED TO INTENSE SCRUTINY

BY THE FERC AS WELL AS THE PIPELINE'S CUSTOMERS AND HAVE BEEN DETERMINED BY THE FERC TO BE "JUST AND REASONABLE" RATES. A PIPELINE CANNOT ARBITRARILY CHANGE THOSE RATES NOR CAN IT ARBITRARILY DEVIATE FROM THE VARIOUS OTHER PROVISIONS IN ITS TARIFF. IN FORMULATING ORDER 436, THE FERC HAD THE EXPRESS OBJECTIVE OF MAKING PIPELINES FINANCIALLY INDIFFERENT AS TO WHETHER THEY PROVIDED THE TRADITIONAL MERCHANT FUNCTION OF BUYING AND SELLING GAS OR WHETHER THEY SIMPLY PROVIDED TRANSPORTATION SERVICES. THE LEVEL OF PIPELINE TRANSPORTATION THAT EXISTED PRIOR TO NOVEMBER 1 WAS THE RESULT OF PIPELINES PURSUING REASONABLE ECONOMIC OBJECTIVES WITHIN THE EXISTING REGULATORY FRAMEWORK. THE REDUCTION IN SUCH SERVICES ON NOVEMBER 1, TO THE EXTENT SUCH REDUCTION OCCURRED, WAS A DIRECT RESULT OF THE FAILURE OF ORDER 436 TO FOSTER THE ECONOMIC INDIFERENCE THE COMMISSION ITSELF RECOGNIZED AS BEING AN ESSENTIAL ELEMENT OF AN OPEN ACCESS TRANSPORTATION POLICY.

THE RESPONSE OF WILLIAMS' TWO PIPELINE SUBSIDIARIES IS VERY ILLUSTRATIVE OF THIS POINT. NORTHWEST PIPELINE ELECTED TO CONTINUE OPEN ACCESS TRANSPORTION FOR AT LEAST THE INITIAL 45 DAY PERIOD WHILE NORTHWEST CENTRAL ELECTED NOT TO DO SO. THIS WAS NOT A CASE OF CORPORATE SCHIZOPHRENIA, IT

WAS A MATTER OF TWO COMPLETELY RATIONAL DECISIONS IN LIGHT OF TWO VERY DIFFERENT FACTUAL SITUATIONS. EARLIER IN 1985, NORTHWEST PIPELINE, AS PART OF A RATE CASE SETTLEMENT, ACHIEVED THE END RESULT OF FORMULATING AN OPEN ACCESS TRANSPORTATION TARIFF WHICH ALLOWED NORTHWEST TO AGGRESSIVELY PURSUE TRANSPORTATION OPPORTUNITIES WHICH EXPANDED THE MARKET DEMAND FOR GAS IN THE PACIFIC NORTHWEST. THE RATE SETTLEMENT PROVIDED FOR COSTS ON NORTHWEST'S SYSTEM TO BE ALLOCATED ON SALES AND TRANSPORTATION VOLUMES PROVIDING NORTHWEST WITH AN INCENTIVE TO ENHANCE THE UTILIZATION OF ITS SYSTEM. IT IS CURRENTLY CONSIDERING THE ADVISABILITY OF CONTINUING SUCH A POLICY BEYOND DECEMBER 14.

NORTHWEST CENTRAL PIPELINE HAS AN EXISTING TRANSPORTATION TARIFF WHICH WAS PUT IN PLACE AS PART OF ITS SETTLEMENT OF A 1982 RATE CASE AND WHICH HAS THE SAME BASIC OBJECTIVES OF INCREASING ITS SYSTEM UTILIZATION. UNLIKE NORTHWEST'S TARIFF, HOWEVER, NORTHWEST CENTRAL'S REQUIRES ESSENTIALLY ALL TRANSPORTATION REVENUES IN EXCESS OF THE INCREMENTAL OPERATING COSTS OF PROVIDING THE SERVICE TO BE CREDITED BACK TO ITS SALES CUSTOMERS. AS A RESULT, IT CLEARLY CANNOT BE INDIFFERENT TO AN OPEN ACCESS TRANSPORTATION PROGRAM WHICH WOULD ALLOW ITS INCOME SOURCES TO BE CONVERTED TO

NON-INCOME SOURCES ON A ONE FOR ONE BASIS. FORTUNATELY FOR ITS PRODUCERS AND TRANSPORTATION CUSTOMERS, VIRTUALLY ALL OF NORTHWEST CENTRAL'S EXISTING TRANSPORTATION AGREEMENTS WERE OF THE TYPE THAT WERE GRANDFATHERED UNDER ORDER 436, SO THERE WAS A MINIMUM DISRUPTION OF SERVICE RESULTING FROM ITS DECISION NOT TO BECOME AN OPEN ACCESS TRANSPORTER ON NOVEMBER 1.

HAVING ADDRESSED THE BROAD CRITICISMS DIRECTED TOWARD THE PIPELINE SECTOR, LET ME TURN BACK TO A SPECIFIC DISCUSSION OF THE CONCERNS WE HAVE WITH ORDER 436.

ORDER 436 IS AN EFFORT TO COMPLETELY RESTRUCTURE THE TRADITIONAL RELATIONSHIPS THAT HAVE EXISTED IN OUR INDUSTRY FOR AN EXTENDED PERIOD OF TIME. SIMPLY STATED, THOSE RELATIONSHIPS WERE ONES BASED ON THE PRINCIPLE OF MATCHING SPECIFIC MARKETS TO SPECIFIC SOURCES OF SUPPLY IN WAYS WHICH WERE INTENDED TO MAINTAIN A REASONABLE BALANCE OVER TIME. ALL OF THIS WAS DONE WITH THE ACTIVE OVERSIGHT OF THE REGULATORY AGENCY (FIRST THE FPC AND NOW THE FERC) TO INSURE THROUGH ITS CERTIFICATE PROCESS THAT THESE BALANCES WERE ACHIEVED AND MAINTAINED AND THAT THE BUSINESS

RELATIONSHIPS CREATED WERE IN THE PUBLIC INTEREST AS A MATTER OF PUBLIC CONVENIENCE AND NECESSITY.

ORDER 436 DISRUPTS THESE BALANCES IN A WAY WHICH LEAVES THE PIPELINE SECTOR EXTREMELY VULNERABLE TO SIGNIFICANT FINANCIAL PENALTIES WITH LITTLE, IF ANY, OFFSETTING OPPORTUNITY FOR FINANCIAL SUCCESS. FIRST, THE ORDER CONFERS A UNILATERAL RIGHT UPON THE PIPELINE'S CUSTOMERS TO RESTRUCTURE THEIR PURCHASE OBLIGATIONS. THE UNILATERAL NATURE OF THAT RIGHT COMPLETELY STRIPS THE PIPELINE OF ANY ABILITY TO NEGOTIATE TERMS AND CONDITIONS THAT WOULD ACCOMPLISH THAT RESTRUCTURING IN A WAY WHICH WOULD BE FAIR TO BOTH PARTIES. IN MY MIND, THE COMMISSION FAILED TO OFFER ANY RATIONAL EXPLANATION AS TO WHY THIS UNBALANCING OF A TRADITIONAL CONTRACT RELATIONSHIP WAS ULTIMATELY IN THE PUBLIC INTEREST. NOR DID THEY SEEM TO EVEN EXPLORE WAYS TO FACILITATE SUCH CONTRACT RESTRUCTURING WITHIN THE EXISTING REGULATORY FRAMEWORK IN THOSE INSTANCES WHEN BOTH THE PIPELINE AND ITS CUSTOMER AGREED IT WAS IN THEIR MUTUAL BEST INTEREST TO DO SO. THEY DID, HOWEVER, RECOGNIZE THAT IN NORTHWEST CENTRAL'S CASE, THERE IS NOT EVEN A STARTING POINT FOR SUCH A PROCESS TO BEGIN AS NORTHWEST CENTRAL'S

CURRENT SALES TARIFFS ARE SINGLE PART VOLUMETRIC RATES WITH NO STATED CONTRACT MINIMUMS OR CONTRACT DEMAND QUANTITIES.

SIMILARLY, ON THE PRODUCING END OF THE PIPELINE, THE COMMISSION'S RULE WOULD CONFER ON THE PRODUCERS THE ABILITY TO SEEK ABANDONMENT SHOULD THEY SUFFER "SUBSTANTIALLY REDUCED TAKES". THIS IS DONE WHILE THE RULE AT THE SAME TIME STRIPS THE PIPELINE OF A NEGOTIATING TOOL WHICH IS ESSENTIAL TO THE BALANCING OF PRODUCER AND PIPELINE INTERESTS. THAT NEGOTIATING TOOL IS THE ABILITY TO ESTABLISH REASONABLE TERMS OF ACCESS TO THE PIPELINE. EXISTING PRODUCER CONTRACTS ESTABLISH TERMS OF ACCESS TO THE PIPELINE AS WELL AS THE OTHER RIGHTS AND OBLIGATIONS OF THE PARTIES TO THE AGREEMENT. PRODUCERS PROVIDE THE COMMODITY AND PIPELINES PROVIDE THE PHYSICAL ACCESS TO MARKETS. THE WILLINGNESS OF PIPELINES TO INCLUDE TAKE OR PAY OR SIMILAR PROVISIONS IN THEIR GAS PURCHASE CONTRACTS WAS CLEARLY PREDICATED ON THE ASSUMPTION THAT THEY WOULD HAVE THE ABILITY TO MATCH PRODUCTION TO MARKETS. BY ALLOWING PRODUCERS AND CUSTOMERS UNILATERALLY TO CHANGE CONTRACT TERMS, WITHOUT REGARD TO THE IMPACT ON THE SUPPLY/DEMAND BALANCE ON THE PIPELINE, LEAVES PIPELINES IN AN UNTENABLE POSITION. AS A MINIMUM, FAIRNESS

AND EQUITY WOULD DICTATE THAT THE MECHANISM FOR MODIFYING CONTRACTUAL RELATIONSHIPS ON EITHER END OF THE PIPELINE BE RESTORED TO A BILATERAL PROCESS AND THE PIPELINE BE PROVIDED A REALISTIC OPPORTUNITY TO MAINTAIN A BALANCE BETWEEN ITS SOURCES OF SUPPLY AND ITS MARKETS. I WOULD POINT OUT AGAIN THAT, EVEN THOUGH IT IS FAR FROM PERFECT, THE EXISTING SYSTEM OF REGULATION HAS PERMITTED A GREAT DEAL OF RESTRUCTING OF CONTRACT RELATIONSHIPS TO TAKE PLACE AT BOTH ENDS OF THE PIPELINE AND HAS DONE SO WITH THE HISTORIC BALANCING OF INTERESTS OF ALL OF THE PARTIES REMAINING A KEY CRITERIA. EVEN THOUGH THE COMMISSION APPEARS QUITE WILLING TO ABDICATE ITS TRADITIONAL ROLE IN ASSURING THOSE BALANCES, IT MUST RECOGNIZE THAT THE ABILITY FOR THE CONTRACTING PARTIES TO CREATE AND MAINTAIN SUCH BALANCES IS STILL IN THE PUBLIC INTEREST.

IN CLOSING, LET ME ONCE AGAIN CITE OUR OWN COMPANY AS ONE EXAMPLE AS TO WHAT CAN BE ACCOMPLISHED UNDER THE EXISTING REGULATORY STRUCTURE. IN EARLY 1983, NORTHWEST CENTRAL'S WEIGHTED AVERAGE GAS COST HAD RISEN TO $3.10/MCF AND IT WAS IN DANGER OF LOSING SIGNIFICANT MARKETS. IT ESTABLISHED A TARGET PRICE PROGRAM WHICH ALTERED PURCHASE PRACTICES

TO ENSURE THAT IT ACHIEVED MARKET SENSITIVE PRICES. THAT IMMEDIATELY CREATED AN EXPOSURE TO HUNDREDS OF MILLIONS OF DOLLARS IN TAKE OR PAY LIABILITY. SINCE THAT TIME, IT HAS NEGOTIATED SUCCESSFULLY WITH ITS PRODUCERS AND PIPELINE SUPPLIERS TO THE POINT THAT IT IS CURRENTLY EXPERIENCING NO NET TAKE OR PAY AND, IN FACT, IS MAKING UP SOME OF THE RELATIVELY MODEST LEVELS WHICH WERE INCURRED IN PRIOR YEARS. IT HAS ALSO REDUCED ITS WEIGHTED AVERAGE COST OF GAS TO $2.08/MCF, A LEVEL EQUIVALENT TO THOSE BEING EXPERIENCED IN THE 30 DAY SPOT MARKET. AT THE SAME TIME, IT INSTITUTED TRANSPORTATION TARIFFS UNDER ITS 1982 RATE CASE SETTLEMENT AND EXPECTS TO MOVE IN EXCESS OF 50 BCF OF TRANSPORTATION GAS DURING 1985, SOME 15% OF ITS TOTAL ANTICIPATED VOLUME FOR THE YEAR.

LIKEWISE, NORTHWEST PIPELINE HAS MADE STEADY PROGRESS IN REDUCING ITS GAS COSTS WHILE MINIMIZING ACTUAL TAKE OR PAY EXPOSURE. IT TOO HAS GREATLY EXPANDED ITS TRANSPORTATION ERVICES THROUGH THE OPEN ACCESS TRANSPORTATION TARIFF IT PUT IN PLACE AS PART OF ITS 1985 RATE CASE SETTLEMENT.

THESE SIGNIFICANT LEVELS OF TRANSPORTATION FOR BOTH COMPANIES HAVE BEEN ACHIEVED THROUGH SETTLEMENT NEGOTIATIONS UNDER

EXISTING REGULATORY STANDARDS AND ON TERMS WHICH ARE MUTUALLY BENEFICIAL TO PRODUCERS, CUSTOMERS, AND THE PIPELINES. WE HAVE ACCOMPLISHED ALL OF THIS WHILE MAINTAINING THE KIND OF A BALANCE BETWEEN THE PIPELINE, THE PRODUCERS, AND THE CUSTOMERS THAT IS ESSENTIAL IF THIS INDUSTRY IS TO REMAIN HEALTHY OVER TIME. WE HAVE DONE SO WHILE MAINTAINING THE TWO HIGHEST RESERVE LIFE INDEXES IN THE INTERSTATE PIPELINE INDUSTRY. COMPETITIVE GAS PRICES, LONG TERM SUPPLY SECURITY, TRANSPORTATION OPTIONS FOR PRODUCERS AND CUSTOMERS AND FINANCIAL EXPOSURE OF THE PIPELINE AND ITS CUSTOMERS TO TAKE OR PAY LIABILITY ARE ALL COMPLEX AND LARGELY INTERDEPENDENT CONCERNS AND THESE ARE CONCERNS THAT WILLIAMS AND ITS TWO PIPELINE SUBSIDIARIES HAVE BEEN ABLE TO ADDRESS SUCCESSFULLY. THESE RESULTS WERE NOT ACHIEVED WITHOUT CONCESSIONS ON THE PART OF ALL SECTORS OF THE WELLHEAD TO BURNER TIP DISTRIBUTION CHAIN, BUT THEY WERE ACHIEVED; NOR DO THEY RESOLVE ALL REMAINING PROBLEMS. PROGRESS HAS BEEN STEADY, HOWEVER, AND IT CONTINUES. I WOULD SUGGEST THAT WE ARE NOT ALONE IN THE INDUSTRY IN HAVING MADE THIS TYPE OF PROGRESS AND THAT, TO VARYING DEGREES, THE BALANCE OF THE INDUSTRY HAS MADE SIMILAR PROGRESS.

ORDER 436 HAS THE VERY REAL POTENTIAL, IF NOT PROBABILITY, OF WIPING OUT ALL OF THE GAINS WE HAVE MADE. IT IS A STEP

BACKWARD THAT PENALIZES MOST OF THOSE COMPANIES WHICH HAVE MOST SUCCESSFULLY DEALT WITH THE PROBLEMS FACING THE INDUSTRY UNDER CURRENT REGULATORY LIMITS.

IT SEEMS TO ME THE FUNDAMENTAL QUESTION BEFORE CONGRESS TODAY IS WHETHER IT WANTS TO ENDORSE THE FERC'S GRAND EXPERIMENT WITH ITS DEMONSTRATED PROBLEMS IN THE HOPE THAT SOMEHOW IT WILL PROVE SUPERIOR TO THE HISTORIC REGULATORY PRACTICES OR WHETHER THE CONGRESS WOULD PREFER THAT FERC SEEK WAYS TO SIMPLY MODIFY THOSE HISTORIC PRACTICES TO FACILITATE AN EASIER TRANSITION IN THE EVOLUTION THAT IS ALREADY WELL UNDER WAY IN THE INDUSTRY. IF, AS I SUBMIT IT SHOULD BE, THE ANSWER IS THE LATTER, IT IS LIKELY CONGRESS WILL HAVE TO INTERVENE IN THE PROCESS AS FERC APPEARS IRREVOCABLY COMMITTED TO THE FORMER COURSE OF ACTION.

FINALLY, I WOULD LIKE TO TAKE THIS OPPORTUNITY TO COMMEND THE COMMITTEE AND YOU, MR. CHAIRMAN, FOR THE CONSCIENTIOUS AND THOROUGH EXAMINATION OF BOTH THE FERC'S NOTICE OF PROPOSED RULEMAKING AND ORDER 436 THAT YOU HAVE UNDERTAKEN. AT A TIME WHEN MANY WERE MORE INTERESTED IN NAME CALLING THAN IN ASSURING THAT PREVIOUSLY EXISTING GAS TRANSPORTATION WAS CONTINUED, YOU HAVE IDENTIFIED THE PROBLEMS THAT CAUSED

GAS TRANSPORTATION TO BE TERMINATED. IN SPONSORING SENATE RESOLUTION 255 WITH SENATOR BOREN, YOU HAVE SOUGHT TO HAVE THE FERC CORRECT THE MANY FLAWS THAT RESULTED IN REDUCED GAS TRANSPORTATION WHEN ITS GOAL WAS TO INCREASE IT, AND YOU HAVE RECOGNIZED THAT THE INTERESTS OF EACH SEGMENT OF THE WELLHEAD TO BURNER TIP DISTRIBUTION CHAIN MUST BE TREATED IN AN EVENHANDED MANNER IF ANY SEGMENT IS TO REMAIN FINANCIALLY VIABLE OVER TIME. WE LOOK FORWARD TO WORKING WITH YOU, THE PRODUCERS, THE CONSUMERS, AND OTHERS TO ASSURE A PRACTICAL, FAIR, EFFICIENT, AND ECONOMICAL TRANSPORTATION PROGRAM FOR EVERYONE'S BENEFIT.

THANK YOU FOR THE OPPORTUNITY TO PRESENT THESE VIEWS BEFORE THIS COMMITTEE. I WOULD BE PLEASED TO RESPOND TO ANY QUESTIONS THE COMMITTEE MIGHT HAVE.

Senator NICKLES. Mr. Bailey, thank you very much.

Our next panelist is Mr. Kenneth Kalen. He is president of Panhandle Eastern.

STATEMENT OF KENNETH E. KALEN, PRESIDENT AND CHIEF OPERATING OFFICER, PANHANDLE EASTERN PIPE LINE CO.

Mr. KALEN. Mr. Chairman, I am president and chief operating officer of Panhandle Eastern Pipe Line Co. and Trunkline Gas Co.

Our pipelines are the wholesale source of supply to 130 distribution companies operating in 12 States.

I am pleased to be here in response to your invitation, Mr. Chairman. We endorse your continuing efforts to bring economic sanity to the gas industry.

I have submitted a comprehensive statement and exhibits for the record. My remarks at this time will be confined to a brief summary of what we regard as the most onerous features of FERC order 436. I shall offer some positive suggestions for modifying order 436, together with a proposal for legislation.

As a company we have never quarreled with the idea of transportation. The fact is that pipelines only earn a profit from throughput, not purchasing and reselling natural gas. Pipelines have gas under contract to meet the legally imposed obligation to serve the needs of their customers.

Without fear of contradiction, I can tell you that the interstate pipelines of the United States take that responsibility seriously. We are receptive to constructive ideas on how to serve that aspect of consumer protection more efficiently. But there is no magic and we have to deal with the problems confronting our industry.

Unfortunately, the roadmap to the future offered by the Federal Energy Regulatory Commission, "Highway 436," is full of deep potholes. Let me cite a few of the more serious.

Order 436 provides for unilateral abrogation of service agreements between participating pipelines and their local distribution customers, LDC's for short.

Order 436 fails to offset the loss of market with any substantive action on the purchase obligations of the pipelines.

As a result of the manner in which the contract demand reduction would work, the existing take-or-pay exposure of pipelines would be made more onerous as firm sales are switched to transport.

Participating pipelines would be confronted with the contradictory circumstance of having to release their customers' purchase obligations without corresponding relief from their own purchase obligations to suppliers.

Equally damaging to all is the real prospect of prolonged litigation and uncertainty.

There is yet another time bomb in the works, but it has not taken final shape. I refer to block billing. It is sufficient for me at this time to say that my company is unalterably opposed to block billing as formulated in the revised proposal.

Contrary to the representations advanced by the FERC, block billing would contravene State proration and conservation regulations and would render a large portion of block 2 gas unmarketable.

This, in turn, would further aggravate the take-or-pay problem.

Moreover, LDC's and end users would be unjustly advantaged in the spot market by giving them the ability to start a new generation of rolled-in pricing with the low-cost old gas, which under NGPA has already been rolled in by the pipelines with what will not be left with the pipelines as unmarketable block 2 gas.

While Panhandle Eastern finds the FERC prescription for the future health of the gas industry creating a potentially more serious malady than the current problems, we want it clearly understood that we have no reluctance to embrace transportation.

Our pipelines have been heavily involved in this emerging new dimension over the last 3 years. During the first 9 months of the year, for example, 29 percent of the gas our pipelines moved into our market area was transport volumes.

Properly structured, transport service can be a useful tool during this interim period of gas surplus.

Incidentally, Mr. Chairman, at the present time, since November 1, our pipeline has been running completely at capacity coming out of Oklahoma and Kansas, so, as Mr. Bailey said, the sources have switched, but the pipelines are running full at the present time. So there is no magic, to all of a sudden having a bunch of spot gas move at the present time.

Let me briefly describe three modifications that the FERC can incorporate in order 436 which will make it reasonably balanced and, at least, livable.

One, as published, the regulations on contract demand reductions and conversions are open-ended and thus assure instability, rate increases and threaten the reliability of service over the long term.

These problems can be eliminated if the CD reduction and conversion are put on a fixed schedule with a one-time election to be implemented in 1986 for the succeeding 4 calendar years with a 25-percent annual limitation. This approach would allow pipelines and LDC's to set a defined course which would reflect their expert knowledge of market needs and afford protection for peak-day service.

Two, the overall program cannot work efficiently without action on both the take-or-pay problem and long-term price provisions unrelated to market conditions. In this regard, we advocate that the producer right of access to transport service be conditioned upon waiver of existing take-or-pay and contract price adjustments to market conditions.

We believe there is ample statutory and judicial authority to impose such a condition. This authority has been presented to the Commission in the "Petition for Rehearing of the Interstate Natural Gas Association of America."

No. 3, and finally, we have strongly urged the FERC to scrap the block billing concept. This idea is so fatally flawed that no amount of tinkering in the review process can make it workable.

I submit, Mr. Chairman, that the adoption of these modifications to order 436 would win wide applause and support by the pipeline industry and the local distribution companies.

I concede that producers are not enthusiastic about giving up what they regard as valid property rights in their contracts. If one postulates the ultimate, it should be recognized that pipelines and gas ratepayers could not handle billions of dollars of take-or-pay claims or the continued burden of paying prices above market levels.

The adjustment of supply arrangements for the long term requires yet one more major change in public policy; namely, the deregulation of all domestic gas production which has not been deregulated.

The truly level playing field can only be created when the commodity price of all gas is established by the marketplace. This means that currently regulated gas must be allowed to come up to the market clearing levels and that production now priced above such levels must come down.

Legislation is the only vehicle that can bring about true commodity pricing based upon market conditions. This kind of result would totally eliminate the need for anything resembling block billing, and would, in my judgment, be an appropriate offset for producers in terms of wiping out the extreme financial hazards of take-or-pay.

Now, Mr. Chairman, I will conclude these remarks with an observation in response to some of the unfounded criticisms that have been leveled at interstate pipelines. That involves the claim that pipelines have not allowed the benefits of recent price decreases to reach the burner tip.

It may come as a surprise to many people to learn that the portion of the consumer dollar paid for gas service and retained by pipelines has remained relatively constant over the past 30 years.

In 1955 pipelines retained 19 percent of the dollar our customers paid for gas service. In 1984 that percentage was 18 percent.

The major shift over three decades has involved the share retained by local distribution companies and producers.

In 1955 that was 70 percent for LDC's and 11 percent for producers. In 1984 the shares were 35 percent for LDC's and 47 percent for producers.

In conclusion, Mr. Chairman, I would urge all participants in the public policy debate on natural gas to take the long-term view. So-called solutions based upon expediency may provide momentary comfort to some, but are not a sound basis for this industry to serve the American people.

Our Nation must have an economically healthy producer community, a financially sound interstate pipeline system and an efficient local distribution network. Anything less would short-change our Nation.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Kalen follows:]

Testimony by
Kenneth E. Kalen, President, Chief Operating Officer
Panhandle Eastern Pipe Line Company
Trunkline Gas Company

Before
Energy Regulation Subcommittee, Senator Don Nickles, Chairman
Senate Energy Committee
Tulsa, Oklahoma
November 27, 1985

My name is Kenneth E. Kalen. I am the President and Chief Operating Officer of Panhandle Eastern Pipe Line Company and Trunkline Gas Company. These pipeline companies are units of Panhandle Eastern Corporation which also has subsidiaries engaged in oil and gas exploration and development and in contract drilling. I have been priviliged to serve my company for 36 years.

I want to commend the Chairman for your devoted attempt to restore economic sanity to the natural gas industry. It is through hearings of this nature that the members of the Senate and the public can be informed on critically important current issues. In the field of energy, few problems can compare in importance with the need to develop and implement sensible public policy for the natural gas industry. It is my hope, Mr. Chairman, that you continue to stimulate the dialogue that might produce that policy - an objective badly served by the content of Order 436, recently adopted by the Federal Energy Regulatory Commission.

Mr. Chairman, my testimony will describe what we believe is the overwhelming primary defect of Order 436. I shall also suggest some ideas which can be the basis for constructive action by both the FERC for the short term and by the Congress for the long term. As an aside, I recognize that obtaining a political consensus for natural gas legislation may be seen as difficult as dealing with the Federal deficit, the trade imbalance and tax reform, but we must all continue to apply our best efforts to those problems.

By way of brief background, I remind the Committee that Panhandle Eastern is a pioneer in the natural gas industry, now completing its 55th year of operations. Today, the Panhandle and Trunkline transmission systems are the wholesale source of natural gas to 130 gas utilities operating in 12 states. Our combined system encompasses more than 17,000 miles of pipeline and related facilities. Our primary market area covers large portions of Michigan, Ohio, Indiana, Illinois and Missouri. The utility customers we supply under long-term service agreements, in turn, serve a population of approximately 24 million people. We estimate that four percent of the gas meters in the United States are directly or indirectly served by our pipeline systems.

On the supply end of the pipeline, we operate in Oklahoma and throughout the Anadarko Basin, in Wyoming and Colorado and on the Gulf Coast, both onshore and offshore.

With that brief summary of our operations, Mr. Chairman, I now turn to the heart of the problems posed by Order 436.

Despite the economic theory upon which the Order appears to be founded, the real world fact is that the provisions of this Order do not fulfill the Commission's stated purpose of ensuring viable and sufficiently competitive markets for natural gas. At the same time, Order 436, when coupled with Block Billing, about which I will have a few words later on, threatens the ability of the gas industry to assure consumers of a reliable, long-term supply of gas at the lowest reasonable cost reflecting changing conditions in energy markets.

While represented as providing a "level playing field" for all market participants, Order 436, in fact, imposes burdens upon pipelines without opportunities to offset their increased risk. This is best illustrated by the right of contract reduction and the transport conversion option made available to local distribution companies - LDCs for quick reference.

The Order creates for LDC's the unilateral and open-ended right of reduction in contract demand at the rate of 25 percent per year and the option - no obligation, but the option - to convert a portion, or all of the released firm sales entitlement to firm transport entitlement. At the same time, the Order provides absolutely no relief to pipelines for existing take-or-pay exposure, recovery of deferred gas purchase costs, or the added take-or-pay exposure that would certainly result from the exercise by LDCs of their newly created "right," as firm sales volume switched away from pipeline contracted supply to spot market sources.

The accompanying right of pipelines to impose a reservation fee for firm transport capacity, hardly adequate as defined, becomes even less important to the extent that LDCs do not opt for firm transport capacity equal to the contract demand reduction. Thus, the potential for reduced recovery of fixed costs is substantial. This circumstance can only engender rate increases through the shifting of costs to the remaining firm contract demand.

The rate implications create instability with serious adverse implications for pipeline earnings and future financings, which would jeopardize the reliability of service -- hardly in the best interest of consumers or the general economy.

In effect, the Commission has created a unilateral right for LDCs to abrogate service agreements with pipelines without benefit of a hearing and a finding, based upon evidence, that such contracts no longer served the "public convenience and necessity." Such a procedure, in our judgement, is clearly in violation of the Natural Gas Act.

The absence of substantive provisions in the Order on the take-or-pay side of this equation is even more egregious. Despite the widespread support voiced in the public comments to the Notice of Proposed Rulemaking, the Commission has concluded that it will not make take-or-pay relief a condition for producers to gain access to transportation service.

The petition for rehearing of Order 436 filed by the Interstate Natural Gas Association of America (INGAA) demonstrates that there is ample statutory and judicial authority for the Commission to condition producer access to transport upon take-or-pay relief. I ask that the INGAA petition be made a part of the record of this hearing.

Aside from the numerous legal defects that infest Order 436 as carefully spelled out in the INGAA filing, logic and fairness would establish that contract abrogation on one end of the pipeline unaccompanied by a compensating reduction of purchase obligation at the supply end of the pipeline is untenable.

Thus, under the Final Rule, LDCs and producers could obtain access to transport service and producers would also have their claims for take or pay preserved in increased amounts.

If nothing else, this circumstance makes a mockery of the so-called "level playing field."

The Commission rhetoric invoked to validate its massive restructuring of the industry and the specific regulations assert the program is "voluntary." Aside from the fact that the FERC lacks statutory authority to impose common carriage status upon pipelines, that assertion is a sham.

The involuntary nature of the program becomes readily apparent upon consideration of any one of a number of its provisions. For instance, the "expedited optional certificates" available to pipelines willing to transport would afford them the opportunity to leave merchant pipelines in their wake.

Merely by monitoring non-transporting pipelines' FERC filings for the names of customers and the terms of transactions for which traditional utility-type approval is sought, transporting pipelines would be able to identify potential customers, file for "expedited" approvals, and be moving gas for their competitors' customers before the latter's traditional request for approval had been scheduled for hearing. Because a pipeline could not expose itself to this kind of "cream skimming," it could not refuse to become a transporter, once any other pipeline in its operating area had done so.

The optional certificate provisions of the Order will also allow new entrants in the pipeline business to engage in cream skimming by building a few miles of pipeline here and a few there without contracting for any gas supply, without the burden of existing service obligations, and without the burden of administering non-discriminatory transport over a far-flung and complex multi-purpose pipeline system.

In the face of such possibilities, there is nothing "voluntary" about an interstate pipeline's decision to perform under Order No. 436.

There is yet another potentially adverse consequence of this part of the rule - namely the bypass opportunity presented to large volume users. The probability of spirited controversy on this issue before 50 state regulatory commissions cannot be seen as beneficial.

My remarks about Order 436 would be deficient without some brief observations about the revised proposal on Block Billing. If ever a Federal regulatory agency created an economic monstrosity, this is it. I will not burden this record with a detailed examination of this concept. That is cogently accomplished by Dr. Paul Carpenter, an economist, whose analysis, already submitted to the Commission, I now submit for the record of this hearing.

It is sufficient for me, at this time, to say that my Company is unalterably opposed to Block Billing as formulated in the revised proposal. Contrary to the representations advanced by the FERC, Block Billing would contravene state proration and conservation regulations and would render a large portion of Block 2 gas unmarketable. This, in turn, would further aggravate the take-or-pay problem. Moreover, LDC's and end users would be unjustly advantaged in the spot market by giving them the ability to start a new generation of rolled-in pricing with the low-cost "old gas" which, under NGPA, has already been rolled in by the pipelines with what will now be left with the pipelines as unmarketable Block 2 gas.

In short, Block Billing has absolutely no redeeming economic value and should be buried in the dark of night without ceremony or witnesses.

Now, you may ask, if Order 436 and Block Billing create even more difficult problems than the industry is currently confronting, what is to be done? Let me offer three specific suggestions for modification of Order 436.

1. The 436 contract reduction right and conversion option formula should be replaced with a one-time election, on a specific date fixed by the pipeline after it has announced its willingness to become a general transporter. That election by the LDC would consist of a fixed schedule to be implemented over four years and at not more than 25 percent of the CD in each year.

   This substitute formula has the advantage of certainty in planning pipeline operations and supply availability, in contrast to the 436 method which is open-ended.

2. The second modification deals with take-or-pay relief and producer access to transport services by a pipeline electing to become a general transporter.

   Gas eligible for transport would be defined as gas produced by a producer (1) which has filed with the FERC a general waiver of accrued take-or-pay liabilities unpaid as of November 1, 1985; and (2) which has agreed with its pipeline purchasers as to contracts entered into prior to November 1, 1985, that, from and after the date of filing the general waiver in (1) above, price provisions for the purchase of any gas other than NGPA Sections 104, 106 and 109 gas will be subject to revision periodically to relate the price for such gas to market sensitive pricing.

3. The third point involves abandonment of the Block Billing proposal for the reasons already discussed.

These modifications will render the transport concept manageable for all parties without bringing onerous burdens to any segment of the industry.

In this regard, I acknowledge that producers will not warmly embrace the notion of waiving outstanding take-or-pay claims. I submit, however, there can be no reasonable belief that producers will ever be able to collect the aggregate of existing take-or-pay claims, to say nothing of those that are continuing to accrue under existing contracts. While a specific number is difficult to ascertain, I believe such claims would aggregate into the billions of dollars -- so vast a sum that they could not be satisfied.

Take-or-pay is the primary impediment to any sensible restructuring of the gas industry. The sooner that realization is accepted, the sooner a realistic solution can be developed. We submit the 436 modification suggested here is a reasonable approach.

The adoption of these changes in Order 436 will be immensely beneficial but there is yet one major step that has to be taken to position the gas industry to make its maximum contribution to the energy welfare of our nation.

That step involves the deregulation of the gas production that has not already been freed of Federal price control. So long as a large portion of gas production remains immune from market forces, economic distortion and market disarray cannot be eliminated. The object here, of course, is to permit the price of controlled gas to reach market clearing levels as an essential step in eliminating pricing distortions and, thereby, permit market forces to balance supply and demand over time.

At the same time, the Congress, however, cannot overlook the need to bring gas which is priced above market levels down to the market. It should be remembered that what is today high cost gas reflects the regulatory environment at the time the contracts were made or is directly derivative of legislated pricing formulas.

To accomplish this, we believe that the benefits of decontrol should only be available to those producers who certify to the Commission purchasers that appropriate revisons have been accomplished to make existing contracts sensitive to market conditions both as to price and take provisions.

Before concluding these remarks Mr. Chairman, there is one other aspect of the public debate on these issues that merits comment. Some producers have been sharply critical of the pipeline industry on two counts. One complaint says:

"I haven't heard of pipelines going broke but a large number of producers are in serious financial difficulty. Don't talk to me about take or pay relief."

And the other comment goes along these lines:

"Look, wellhead prices have come down but pipeline margins have increased and consumers are not getting the benefits of lower prices."

We recognize that there are hard times in the oil patch. A lot of business interests have and are suffering financial distress. The net income of my Company declined 37 percent between 1981 and 1984 and was down by 32 percent for the first nine months of this year as compared with September 30, 1984. A wide range of adverse factors are affecting the oil and gas industry; but the least of them is the transport behavior of pipelines.

Our pipelines have been extensively involved in providing transport service, apart from merchant operations, in the last three years. For the first nine months of this year, for example, transports represented 29 percent of the volume moved into our market area.

Lest anyone remain in the dark, let me emphasize with all the strength that I can muster that pipelines make no profit whatsoever by purchasing and reselling gas. The earnings of a pipeline come from throughput. Pipelines own gas because of the legally imposed obligation to fulfill service agreements. The gas purchase contracts which are causing take-or-pay problems are also the essential source of gas to fulfill our service obligation to customers, particularly on peak days.

Now, for the last matter -- where has the money gone from escalating gas prices in recent years? It may come as a surprise to many to learn that the pipeline portion of the consumers dollar paid for gas service has remained relatively constant over many, many years. My remarks submitted for the record contain a chart showing the proportional relationship of the consumer dollar retained by producers, pipelines and LDCs based upon the value added by each industry segment.

In 1984, the last full year for which objective data are available, pipelines kept 18 percent, LDCs 34 percent and producers 48 percent. The pipeline share was 25 percent and the producer share was 41 percent in 1978 before the effect of the NGPA impacted prices, in contrast to 1955 when the producer share was 11 percent and the pipeline share 19 percent.

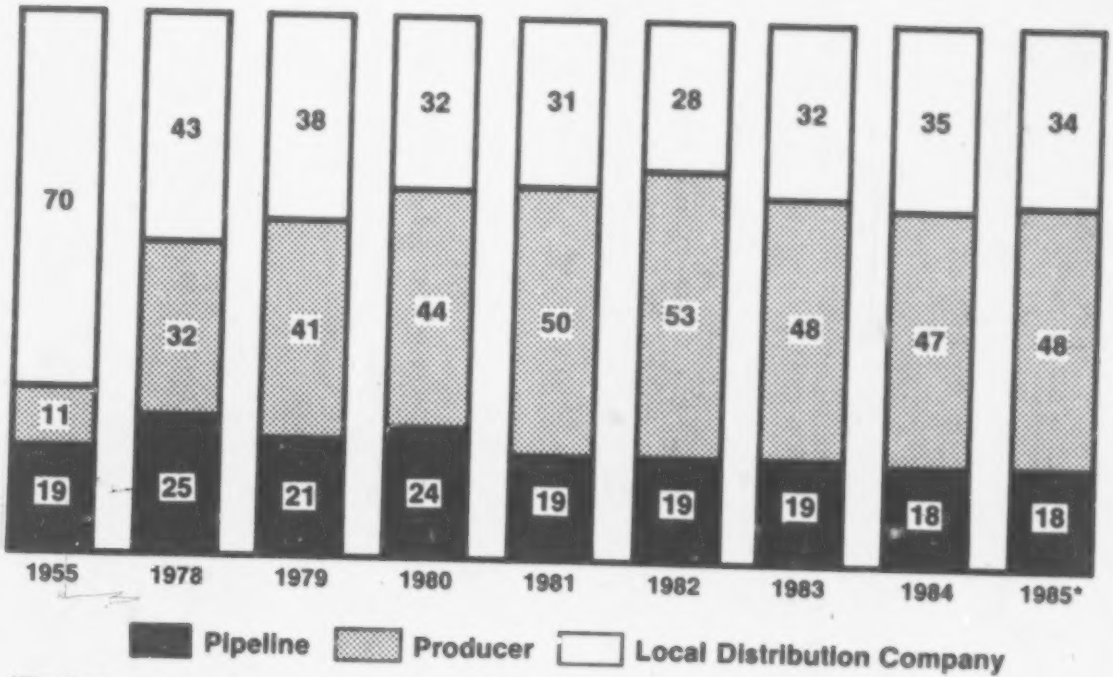
What this analysis says, of course, is that regulated pipeline rates, exclusive of the cost of gas, have been held relatively constant over the years. This data came from the Energy Information Agency of the Department of Energy.

I cite these percentages to set the record straight. History clearly shows us that wellhead prices were kept artificially low by misguided Federal price controls for too many years. The nation needs -- must have -- an economically healthy producer community. Exploration carries substantial risk and should be fairly rewarded.

In conclusion, Mr. Chairman, I want to reiterate our devotion as a Company to participate constructively in the formulation of new public policy for the gas industry from a long-range point of view. Expediency, at best, can provide a temporary BandAid. Our nation needs a strong gas industry from the wellhead to the burner tip.

Consumers' Gas Dollar

% share by industry



*First four months

Source:
1955 Data: American Gas Association
1978-85 Data: Department of Energy/Energy Information Administration

DEPARTMENT OF ENERGY
BEFORE THE
Federal Energy Regulatory Commission
WASHINGTON, D. C.

[illegible] 1:58

Regulation of Natural Gas Pipelines)
After Partial Wellhead Decontrol)

Docket No. RM85-1-000
(Parts A-D)

PETITION OF
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
FOR REHEARING

Pursuant to Section 19(a) of the Natural Gas Act (NGA), Section 506(a)(2) of the Natural Gas Policy Act of 1978 (NGPA), and Rule 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (Commission), the Interstate Natural Gas Association of America (INGAA) respectfully requests that the Commission grant rehearing of its Order No. 436, issued October 9, 1985.

In support of this Petition, INGAA shows as follows:

I.

BACKGROUND

On May 30, 1985, the Commission issued a Notice of Proposed Rulemaking (NOPR) to fundamentally restructure the interstate natural gas pipeline industry by amending its regulations. The stated purpose of this restructuring was to "ensure that...natural gas markets are viably and sufficiently competitive so that consumers are provided gas at the lowest reasonable rates consistent with reliable, long term service." (NOPR at 3).

The interstate pipeline industry supported the Commission's stated goal. To this end, INGAA filed detailed comments on July 15, 1985, suggesting a number of positive modifications to the NOPR. The modifications were proposed in order to better assure that all sectors of the natural gas industry - producers, pipelines, distributors, brokers, etc. - would be placed in comparably competitive market positions.

On October 9, 1985, the Commission issued Order No. 436, the Final Rule in this docket. Part A of the Final Rule implements a new transportation program that replaces existing special marketing programs as well as existing transportation programs under NPGA Section 311 and Commission Order Nos. 60, 63, 234-B and 319. This new transportation program introduces a set of mandatory rate conditions applicable to all participants in the program. The rate conditions include an open-access non-discriminatory transportation requirement plus permission to pipeline customers, on their own volition, to either convert to firm transportation or to totally reduce at a rate of 25 percent per year their sales contract demand requirements. In addition, the program imposes a "first-come, first-served" principle of capacity allocation notwithstanding on-going contractual commitments that have been certified by the Commission as being in the public convenience and necessity under the NGA.

Part B, as proposed in the NOPR, was intended to address what the Commission itself has recognized to be one of the most egregious problems facing the industry i.e. onerous take-or-pay obligations to producers.1/

1/ See, e.g. Petition of the Federal Energy Regulatory Commission for Rehearing and Suggestion for Rehearing En Banc, filed June 24, 1985 in Maryland Peoples Counsel v. FERC, No. 84-1019, D.C. Circuit, where the Commission observed: "[T]ake or pay is an overarching impediment in the movement toward a more competitive market, and more specifically to broader pipeline transportation programs." (Petition at 8).

Despite valid and workable proposals to deal with this severe problem by INGAA and others, the Final Rule provides no viable take-or-pay relief beyond that provided for in the Commission's existing Policy Statement, 50 *Fed. Reg.* 16,076 (April 24, 1985). While effectively ignoring this critical problem confronting pipelines, the Final Rule does provide producers expedited abandonment of their commitments to sell gas previously dedicated to interstate commerce and allows firm sales customers to reduce their previously contracted contract demand or convert that sales service to firm transportation service thereby further exacerbating take-or-pay exposure.

Part C of the Final Rule, involving optional expedited certificates, creates an entirely new method of processing applications for new service facilities. Yet it conditions the availability of those expedited procedures as to new transportation facilities on participation in the new transportation program. *See* Final Rule; Technical Corrections, issued October 24, 1985, in Docket No. RM85-1-000.

Finally, Part D of the NOPR, relating to a proposed block billing mechanism, is not adopted at all. Despite public pronouncements by individual commissioners and even recognition in the Final Rule that no part of the rule would work unless all were adopted, the Order defers action on Part D pending consideration of supplemental comments. *See* Notice Requesting Supplemental Comments, issued October 9, 1985, in Docket No. RM85-1-000 (Part D), at 20.

II.

GROUNDS FOR REHEARING
AND
SPECIFICATION OF ERRORS

INGAA has attempted throughout this proceeding to offer constructive recommendations to assure that the stated goal of viable competitive markets with stable long-term supply and a "level playing field" for all market participants is achieved in a practical, efficacious, and legally sound manner. While INGAA's comments were not totally ignored, those that addressed attaning the goal of comparably competitive market conditions were rejected. INGAA submits that this failure to weigh our recommendations and the reasoning behind them is itself an arbitrary and capricious exercise of the Commission's authority. But apart from these general deficiencies, there also are a host of specific ones which, we submit, constitute grounds for rehearing and to which we now turn.

A. Order No. 436 is so patently biased against interstate gas pipelines as to be arbitrary and capricious and, therefore, unlawful.

Order No. 436 does not fulfill the Commission's stated purpose herein of ensuring viable and sufficiently competitive natural gas markets. Nor does it assure that consumers are provided gas at the lowest reasonable rates consistent with reliable, long term service or that all sectors of the natural gas industry are placed in comparably competitive market positions. Indeed, INGAA submits that Order No. 436 is unduly biased against the interstate pipeline segment of the gas industry. Order No. 436 presents interstate natural gas pipelines with a no-win situation, a Hobson's choice between suffering competitive disadvantages of not participating in the new transportation program and many legal and economic wrongs likely to be suffered if they do participate.

By way of example, and as demonstrated further below, a pipeline which participates in the transportation program on a fully committed basis is confronted with:

(a) reductions and conversions by firm sales customers;

(b) increased take-or-pay exposure and no relief from existing take-or-pay;

(c) basic loss of operational control, e.g. allocation of capacity on a first-come-first-served basis;

(d) imbalance between transportation and sales service; and

(e) increasing fixed costs for remaining customers.

The alternative of not participating in the transportation program on a fully committed basis confronts pipelines with:

(a) losing revenue from new transportation service;

(b) having issuance of traditional NGA Sec. 7 certificates delayed "in the normal course of business at the FERC" which, in effect, renders the pipeline incapable of competing for transportation loads;

(c) increasing fixed costs for remaining customers;

(d) having the Commission condition Sec. 7 certificates in the same way as the self-implementing transportation certificates; and

(e) being penalized in rate cases.

Additionally, regardless of whether the pipeline participates or not, it faces the prospect of great uncertainty, potential litigation as well as expedited abandonment by producers of their contractual obligations to sell gas previously dedicated for sale in interstate commerce.

The cumulative effect of these changes is that the playing field has been tilted heavily against the interstate pipeline industry. This is clearly contrary to the Commission's often stated goal of creating a level playing field. INGAA therefore urges the Commission to grant rehearing of Order No. 436 and to revise its Final Rule in accordance both with INGAA's initial comments in this docket and this Petition for Rehearing. Only in that way can the arbitrary bias against pipelines in the Final Rule be excised and the goal of a "level playing field" be reasonably achieved.

B. By failing to deal with the recognized problems of take-or-pay confronting interstate pipelines in their contractual relations with gas producers, the Commission in Order No. 436 fails to meet its statutory obligations to the consuming public.

In its May 30, 1985 NOPR, the Commission proposed a limited form of relief to pipelines facing large take-or-pay obligations to gas producers. There were problems with the Commission's proposal and INGAA, among others, pointed out these problems. See INGAA's NOPR comments.

At the same time, however, INGAA recognized the severity of the take-or-pay problem. Pipelines representing over two-thirds of the interstate market reported an accumulated take-or-pay exposure in 1984 of $5 billion. Additional exposure in 1985 was estimated at $3 billion and for 1986 and 1987 many times greater. Potentially, these costs could be payable by gas consumers if nothing is done by the FERC.

Unfortunately, in Order No. 436, the Commission announced its decision to do nothing to resolve the take-or-pay dilemma. This is so even though the Commission itself has recognized that "take-or-pay is an overarching impediment in the movement toward a more competitive market, and more specifically to broader pipeline transportation programs." See note 1 supra. Instead of acting on this fact, however and conditioning producer access to the transportation program on take-or-pay relief the Commission withdrew the proposal for take-or-pay relief, and issued a rule reflecting not a level playing field, but a strong anti-pipeline bias.

As if this were not bad enough, chances for dealing with the take-or-pay problem have been diminished even further by Order No. 436's contract abrogation and open access provisions. Under Order No. 436, pipelines confronted with unilateral reductions in the contract demand of their customers and open access to transportation for all comers on a firm or interruptible basis will face an additional unanticipated potential take-or-pay exposure to their suppliers. Without some form of relief, pipelines will confront an unexpected drain on their revenues and the pipelines' so called captive customers will be confronted with an increased share of total take-or-pay costs.

The Commission's adamant refusal to deal with these problems and to protect pipelines and consumers is in derogation of its primary duties under the NGA. As the Supreme Court recognized in FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944), natural gas pipeline "rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong." FPC v. Memphis Light, Gas & Water Division, 411 U.S. 458, 474 (1973) (emphasis added). Yet, INGAA submits, without take-or-pay relief, the financial health of the pipeline industry is jeopardized and, consequently, the rate structure promulgated in Order No. 436 cannot be just or reasonable.

Moreover, consistent with our comments on the NOPR, INGAA believes that there is a ready solution to the problem of take-or-pay. INGAA reiterates its recommendation that the Commission condition producer access to interstate pipelines under the new transportation program on adequate take-or-pay relief. The Commission, in Order No. 436, rejected this proposal, inter alia, on the theory that it does not have authority to so condition producer certificates and that such a condition would defeat the purpose of its open access condition. (Order No. 436 at IV.A.45).

INGAA respectfully disagrees with both of these conclusions for the following reasons:

1. The Commission has broad conditioning powers under Section 7 of the NGA. In the landmark case in this area, the Supreme Court held that the Commission has the power expressly granted by Section 7(e) of the NGA, 15 U.S.C. Section 717f(e), "to attach to the certificate...such reasonable terms and conditions as the public convenience and necessity may require." Atlantic Refining Co. v. Public Service Commission, 360 U.S. 378 (1959). As long as the conclusion upon which the condition is based is reasonable and supported by the record, the conditioning power is to be interpreted expansively. Id.; Distrigas Corp. v. F.P.C., 495 F.2d 1057, 1064 (D.C. Cir. 1974) cert. denied, 419 U.S. 834 (1974).

Furthermore, in the leading case of the Federal Power Commission v. Transcontinental Gas Pipe Line Corporation, 365 U.S. at 5 (1969) (Transco "X-20" case), the Supreme Court held that the Commission has jurisidiction not simply to condition a certificate but rather to outright deny its authorization based upon the Commission's concern that the public interest would suffer if the certificate were granted. This jurisdiction exists despite the fact that the underlying transaction, a direct sale from producer to end-user (Con Ed), was non-jurisdictional.2/

2/ The Supreme Court in Transco characterized the Commission's transportation authority as a "veto" power over objectionable proposals. 365 U.S. at 17. Such a "veto" power is to be contrasted with the limits of the Commission to positively order or otherwise compel that something be done. While the Commission has authority to veto or prevent transportation not in the public interest, it hasn't the authority to order or mandate that transportation take place. Thus the Commission may condition transportation on a grant of take-or-pay relief by producers because the take-or-pay clause, when coupled with an open transportation policy, is contrary to the public interest; on the other hand, the Commission cannot order -- either directly or indirectly -- a pipeline to transport gas which it does not want to transport. See INGAA's NOPR Comments at 22-23.

The factors considered by the Commission in the Transco X-20 case were that the direct sales would divert gas from higher priority uses and that the entry into the wellhead purchase market of end-users would increase the price of natural gas in the field (by triggering a rise in the price provisions of other contracts). The Supreme Court in Transco took a long look at the development of the Commission's Section 7 powers and concluded that the Commission's duty to regulate in "the public convenience and necessity" included the power to consider the foregoing end-use and price factors related to a non-jurisdictional contract which depended upon a jurisdictional transportation service.

In an analogous situation, the Fifth Circuit held that the Commission has power under Section 7 to affect direct sale contracts which are outside the Commission's jurisdiction. Florida Power and Light v. FERC, 598 F.2d 370 (5th Cir. 1979) cert. denied, 444 U.S. 1013 (1980) (Florida Power and Light). In Florida Power and Light, the Commission conditioned the transportation certificate issued to Amoco so as to guard the interests of high-priority users of natural gas at a time of shortage. The Commission ruled that the gas to be transported could not be used in the purchasers' low-priority boilers. Although this condition severely hampered Amoco's ability to meet its contractual obligations under warranty contracts with its purchasers, nonetheless, the Court found that:

> ...the Commission is not required to approve blindly applications for certificates which may be sought in connection with the performance of long-term contracts but is required to approve each such application taking into account current standards of public convenience and necessity. 598 F.2d at 378.

Moreover, in another case, the District of Columbia Circuit likewise concluded that "because the Commission cannot regulate directly the prices paid for gas in such [non-jurisdictional] transactions, it must rely on its authority to impose conditions in certificates to...protect the public interest." Brooklyn Union Gas Company v. FERC, 627 F.2d 462, 466 (D.C. Cir. 1980).

The foregoing cases make clear that the Commission has the power to condition certificates so as to affect take-or-pay clauses to the extent necessary to protect the public interest. This conditioning power includes the suggested condition to producer access to the new transportation program. All that is required to accomplish such a condition is to find that the financial viability of pipelines -- otherwise impossibly compromised by the combination of open transportation and take-or-pay obligations -- is as much a part of the public interest as the "end-use" and "price" considerations which have been held by the foregoing cases to be in the public interest.3/

To the extent there is concern that such a condition is impermissible indirect regulation of deregulated gas, the foregoing cases show that Commission orders can indeed affect non-jurisdictional entities and transactions, and still be within the Commission's statutory bounds. Indeed, the end-user direct sale contracts which were affected in the Transco X-20 case and in Florida Power and Light were as non-jurisdictional as those contracts containing the take-or-pay clauses, which contracts are no longer subject to Commission price control.

The proposed condition, moreover, would apply to the pipeline

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3/ The Commission has already recognized that take-or-pay clauses are causing "problems" by their effect on gas prices and supply/demand equilibrium and such problems are certainly not in the public interest. Statement Of Policy Concerning Take-or-pay Provisions In Gas Purchase Contracts, 47 Fed. Reg. 57268 (December 23, 1982), see also footnote 1, supra.

transportation certificate, not to producer contracts.4/ The producer is not required to relinquish any of its contractual take-or-pay rights, but rather is put to the election of (i) preserving such rights or (ii) trading those rights for open self-implementing transportation. The transportation program established by Order No. 436 marks a new era in the natural gas industry, one which was not envisioned in the historical period during which the take-or-pay clauses were created. Because the producer is free to elect to compete under the old rules, it cannot be said that the Commission is attempting to exercise any jurisdiction over those gas purchase contracts.

In fact, there is precedent for the Commission giving producers such an election to trade take-or-pay entitlements for transportation. In the Commission's SMP's (which were not challenged on this basis), the Commission conditioned the abandonment and transportation authority granted therein by a limitation on the markets to be served and by a requirement that producers forgive take-or-pay pro *tanto* for the SMP volumes transported. That action had the same "indirect" effect on producer contracts that the condition being considered here would have:

4/ This is an activitiy which is clearly within the ambit of the Commission's regulatory jurisdiction under Section 1(b) of the NGA. *Panhandle Eastern Pipeline Co.* v. *Public Service Comm'n*., 332 U.S. 507, at 516 (1947). The Commission's authority under NGA Section 1(b) to regulate in the public interest the terms and conditions on which such *transportation* is to be performed is *not* limited by any restrictions as may otherwise constrain the Commission's exercise of jurisdiction over sales. *Transco X-20*, *supra* and *Florida Power and Light*, *supra*; Cf *FPC* v. *Louisiana Power & Light Co*., 406 U.S. 621 (1972). The fact that the NGPA may deny the Commission the authority to regulate certain first sale transactions, *Pennzoil Co.* v. *FERC*, 645 F.2d 360 (5th Cir. 1981), *cert. denied*, 434 U.S. 1141 (1982), is of no more consequence in assessing its power to apply the proposed condition in authorizing pipeline transportation than was its lack of authority to regulate retail sales in the *Transco X-20* case *supra*, etc.

the producer has the choice of retaining his take-or-pay rights while foregoing new markets or of reaching such new markets by relieving the pipeline of the obligation to purchase the same gas. In addition, the SMP's required reports from non-jurisdictional entities such as distributors and end-users in order for those entities to qualify for participation. This is a second manner in which the Commission's SMP program affected matters or entities outside the Commission's jurisdiction.5/

Nor does the proposed condition constitute undue discrimination.6/ The condition is not unduly discriminatory because it does not exclude any class from access to the benefits of transportation. Rather, the proposed condition is consistent with the NGA which has as its primary purpose protection of "consumer interests against exploitation at the hands of the natural gas companies," Sunray Mid-Continental Oil Co. v. FPC, 364 U.S. 137, 147, 151-54 (1960); FPC v. Hope Natural Gas Co., 320 U.S. 591, 610 (1944), including gas producers.

2. INGAA is at a loss as to how this conditioning of producer access, as the Commission implied in Order No. 436, would defeat the purpose of open access. Indeed, INGAA maintains that open access will, if retained on rehearing, be enhanced by meaningful take-or-pay relief. Without take-or-pay relief, on the other hand, the open access requirement

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5/ Of course, the fact that the Commission placed similar conditions on certificate authorizations in the past does not necessarily -- in the absence of judicial affirmance -- mean that the use of such conditions in another instance is lawful: not all "indirect" measures are valid. The examples are provided only to demonstrate that the Commission has in the past exercised its jurisdiction in a manner nearly identical to the relief here requested by pipelines.

6/ See generally, INGAA comments in Docket No. RM85-1 at 18-19.

will, as shown infra, only exacerbate the take-or-pay problem by allowing more and more sales customers to swing off-system. In this regard, the Commission has consistently maintained that all parts of its rulemaking were inseparably linked such that they could not work if only partially implemented. Take-or-pay relief is one of those inseparable parts and we urge the Commission to take further action herein to assure the "level playing field" to which it referred frequently in the initial stages of this proceeding.

C. Order No. 436 seeks to unlawfully coerce interstate pipelines to accept a potentially irrevocable common carrier obligation to transport gas for all comers.

It is beyond dispute that the Commission is without authority to treat interstate natural gas pipelines as common carriers. See, Mogel and Gregg, Appropriateness of Imposing Common Carrier Status on Interstate Natural Gas Pipelines, 4 Energy Law Journal 155 (1983) and Reiter, Competition and Access to the Bottleneck: The Scope of Contract Carrier Regulation under the Federal Power and Natural Gas Acts, 17 Land and Water Review (1983). As the Federal Power Commission, the predecessor of the present Commission, observed:

> Under...the Natural Gas Act, the Commission has the power to establish rates and other conditions for the sale and transportation of natural gas in interstate commerce, but the Commission does not have the power to force a natural gas producer to search for gas in a particular location or to commence the sale of natural gas in interstate commerce....Nor [as the United States Supreme Court has stated] do we have the power to order a natural gas company to sell gas to users that (the Commission) favors; (we) can only exercise a veto power over proposed transportation....7/

7/ Opinion No. 699, Just and Reasonable Rates for Sales of Natural Gas, 51 FPC 2212, 2289 (1974); quoting F.P.C. v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1, 17 (1961).

The same is true with respect to the NGPA as well.8/ Nor is it open to question that an obligation to transport a commodity for all comers on a non-discriminatory basis is one essential attribute of a common carrier. Mogel & Gregg, supra.

The Commission, however, denies that through the non-discriminatory open access condition attached to its new blanket transportation program it seeks to treat interstate pipelines as common carriers. On the other hand, the Commission finds that refusal of a pipeline to transport gas for a sales customer is per se unjust and unreasonable. The Commission's denial that the effect of Order No. 436 will be to treat interstate pipelines as common carriers is based on two faulty assumptions.

First, the Commission maintains that participation in the transportation program is purely voluntary. As shown below, for many pipelines, this may not be the case. Second, the Commission maintains that its authority to attach such an open access condition is incidental to its broad conditioning authority under Section 7(e) of the Natural Gas Act. Given the decisions of the United States Court of Appeals, in Maryland People's Counsel, 761 F.2d 768 and 761 F.2d 780 (D.C. Cir. 1985), this might be true at least as to Order No. 234-B transportation programs and SMP's, provided the program were completely voluntary, but as

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8/ The Commission's attempt to coerce interstate pipelines to undertake transportation pursuant to Section 311 on a common carrier basis is ultra vires the NGPA. Section 602(b) of the NGPA provides explicitly that, "No person shall be subject to regulation as a common carrier under any provision of Federal or State law by reason of any transportation...authorized by the Commission under section 311(a) of this Act."

indicated, it clearly does not appear to be voluntary.9/

The involuntary nature of the new transportation program would be apparent, for example, where a pipeline finds that it cannot afford the option of non-participation. Thus if a competitor of Pipeline A participates in the transportation program, and thereby achieves a competitive edge, Pipeline A may find that it has no choice but to participate, notwithstanding the legal and operational disadvantages. There will be no other practical avenue open to the pipeline such as SMP's, existing blanket transportation programs or other innovative transportation arrangements. Order No. 436 replaces all such programs and thereby deprives pipelines of a major source of revenues and the consuming public of the most successful proven methods of expediting the transportation of gas in interstate commerce that have yet been developed.10/ As demonstrated in the "Response of Interstate Natural Gas Association of America in Opposition to Motions to Enforce Mandate" filed on October 28, 1985 in Maryland Peoples Counsel v. FERC, Nos. 84-1019, 84-1090, 85-1029, and consolidated case 85-1086, this result was not required by the Court's mandate.

9/ The Commission also states that the open access conditions, even if accepted do not impose an affirmative duty to transport, but only require that if one does transport, such transportation must be provided in a non-discriminatory manner. INGAA maintains that this argument is frivolous. If one "participates" in the program but does not transport, it is tantamount to not participating at all.

10/ The quarterly volume of gas transported for distributors and end users increased to more than 16 percent of the total volume delivered to market by interstate pipelines in the second quarter of 1984. In the second quarter of 1985, these pipelines transported about 215 bcf of natural gas for distributors and almost 200 bcf for end users. This is an increase of approximately 50% over the same period in 1984.

The only alternative recourse left to interstate pipelines is traditional NGA Section 7 certificating authority which often takes months, even years to obtain and is limited to individual transactions. Thus by the time a traditional Section 7 certificate is obtained, it is likely that another entity will have acquired the gas supply involved in the proposed transportation and possibly the same or even a third entity will have successfully provided the transportation service sought by the shipper.11/

The transportation program is an apparent attempt to coerce pipeline participation in another respect as well, since it is the only means whereby pipelines can take advantage of expedited procedures for the construction of new transportation facilities. See, Final Rule; Technical Corrections, issued October 24, 1985, Docket No. RM85-1-000.

At various places in its Order, the Commission articulates a philosophy of making pipelines economically indifferent in choosing to be transporters or merchants of gas. Economics aside, the procedures adopted in the Order put transportation ahead of new sales. Virtually all pipelines perform a significant transportation service and depend upon the resulting revenues. By attempting to coerce pipelines to transport, if at all, on a "first-come, first-served" basis and by vesting sales customers with the unilateral right of contract abrogation, it is hard to imagine how pipelines will be able to maintain their role of gas merchant. INGAA submits, therefore, that Order No. 436 will virtually "squeeze" many pipelines as merchants into the mold of involuntary transporters of gas

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11/ The frustration from delay in obtaining traditional Section 7(c) authority is aggravated by the significant fee of $12,200 attached to such a filing (Order No. 433). No similar fee is required of participants in the new transportation program.

for all comers.12/ The Commission cannot utilize an indirect attempt to subject interstate pipelines to common carrier obligations.13/

D. The capacity allocation mechanism of Order No. 436 unlawfully ignores the supply requirements of existing customers.

In Granite City Steel Company v. FPC, 320 F.2d 711 (D.C. Cir. 1963), the D.C. Circuit interpreted NGA Section 7(a) to prevent the reallocation of capacity from one group of customers to another group, when such reallocation would interrupt service to existing industrial customers. The holding in Granite City reflects the well-established principle that one of the Commission's primary responsibilities under the NGA is the assurance of stable long-term supply arrangements.

Order No. 436 ignores this principle. The Commission, in Order No. 436, has coupled its non-discriminatory access condition with an unprecedented "first come, first served" capacity allocation mechanism and, as described below, with the right of some existing sales customers to unilaterally abrogate their contractual obligations to buy gas. However the new allocation mechanism and the unilateral abrogation rights will work in practice, which is unclear from the rule itself, it is obvious that the allocation mechanism and the abrogation rights are being adopted without regard to protecting the interest or security of existing customers in reliable long-term supplies of gas. Under the Final Rule, pipelines are losing the ability to manage their own systems so to provide

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12/ This is true in another respect as well. As explained infra, by permitting the firm sales customers of interstate pipelines to convert their sales contract demand rights into transportation rights, the participating pipeline is coerced into offering even additional non-discriminatory transportation services.

13/ The Commission cannot do indirectly that which it cannot do directly. Central West Utility Company v. F.P.C., 247 F.2d 306 (3rd Cir. 1957), see also footnote 8, supra.

for the long-term needs of their existing customers. By this impairment of the ability of pipelines to render adequate service, the Commission has shirked its role of consumer protector and opted thereby to violate its own statutory mandate.

E. Order No. 436 unlawfully permits pipeline customers to unilaterally and permanently abrogate sales contracts and service agreements and permits unlawful abandonment of previously approved certificates of public convenience and necessity.

If a pipeline "chooses" to participate in the new transportation program, Order No. 436 permits the pipeline's existing firm sales customers to abrogate their contracts and service agreements to purchase gas by one of two means. They may either reduce their sales contract demand to zero at a rate up to 25 percent per year or they may convert that contract demand to a right to firm transportation service at the same rate but not in excess of an amount equal to or less than the sales contract demand being relinquished.

The choice to reduce or to convert sales contract demand is left solely in the hands of the pipeline's customers. Conversion, in fact, may be had upon only 60 days prior notice to the pipeline.14/ These reduction and conversion rights represent a marked change from long-standing practice whereby firm sales entitlement levels were established by mutual contractual agreement between pipelines and their customers. Furthermore,

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14/ The 60 day notice is too brief if pipelines are intelligently to plan to meet the long-term supply requirements of their customers at the lowest reasonable rate. It would be more realistic to require notice to be filed by all so converting at the same time annually, effective nine months thence.

the Commission unlawfully has failed to make the factual findings required of it to support with substantial evidence such a change from a long-standing practice. See Columbia Gas Transmission Corp. v. FERC, 628 F2d. 578, 586, n.31 (D.C. Cir. 1979).

Yet the right of customers to abrogate their contracts and service agreements is more than just a radical departure from an established practice. It also abrogates the contracts on which the entire gas industry is predicated without the necessary finding under NGA Section 5 that the existing contracts are unlawful or that there are "circumstances of unequivocal public necessity" warranting abrogation. Permian Basin Area Rate Cases, 390 U.S. 747, 822 (1968).

The destabilizing effect of allowing unilateral contract abrogation both upon the pipelines and the consuming public cannot be overestimated. There simply is no telling how long-term service arrangements and the security of supply will bear up. The Commission has focused unduly on spot market considerations. It has thus ignored the fact that a critical purpose of its responsibilities under the NGA is to provide for stable long-term supply arrangements, which are essential for the health of the natural gas industry and, ultimately, for the consuming public. See, e.g. United Gas Pipeline Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956). The Commission also thereby has neglected the likely consequences of its action, which will result in unanticipated difficulties to interstate pipelines in their efforts to obtain long-term supplies of gas necessary to meet on-going service obligations. Such disregard of the detrimental impact of the Order is unlawful in itself. See, State of North Carolina v. FERC, 584 F.2d 1003, 1014 (D.C. Cir. 1978); F.P.C. v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944); and Mobil Oil Corporation v. F.P.C., 417

U.S. 283, 313 (1974).

Furthermore, to the extent that service under a contract has been certificated by the Commission, the right of customers to abrogate such contracts[15] also constitutes a unilateral right to abandon the certificated service. In bestowing this unilateral right of abandonment upon pipeline customers without a proper factual showing that abandonment is in the public convenience and necessity, the Commission has violated NGA Section 7(b).

Section 7(b) permits abandonment only upon a Commission finding, based on substantial evidence, that the present or future public convenience and necessity supports it. See, *e.g.* *United Gas Pipe Line Company* v. *McCombs*, 442 U.S. 529 (1979). While the Commission certainly is not precluded from making generic changes by rulemaking in the procedures by which it treats abandonment applications,[16] the NGA still requires certain factual findings supported by substantial evidence as a prerequisite to the issuance of abandonment authority. Such findings must address, for example, the specific impact upon the pipeline and upon all customers affected by the abandonment. *Id.*

The Commission's Order does not attempt such a factual inquiry. Nor does it contain findings that the public convenience or necessity requires the unilateral abandonment of certificated services. Without these findings based on substantial evidence, the Commission's economic rationale, *e.g.* that customers will receive benefits of increased competition,17/ hardly suffices to support what it has done in Order No. 436. Indeed, what the Commission has done is not merely to permit the unsubstantiated abandonment of previously authorized certificates. This is unlawful in itself, as just indicated. What the Commission has done, in fact, is grant permission for *others* to impose abandonment of certificates upon pipelines. Those "others" are themselves interested persons, namely the pipeline's own customers. No precedent found supports the authority of regulatory agencies to delegate their statutory responsibilities in such fashion. The Commission thus has clearly shirked its duties under the NGA and has acted unlawfully in the process.

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[15] Significantly, the Commission does not state that it is exercising its own limited NGA Section 5 authority to abrogate contracts in "circumstances of unequivocal public necessity." *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 *rehearing denied*, 392 U.S. 917 (1968). Indeed, the Commission, nowhere in the vastness of Order No. 436 undertook any sort of examination of the terms and conditions of the specific contracts which may be abrogated. The Commission erred in making no pertinent findings under Section 5.

[16] *Cf.* *Wisconsin Gas Co.* v. *FERC*, 770 F.2d 1144 (D.C. Cir. 1985) as to minimum commodity bills.

F. *In Order No. 436, the Commission has exceeded the lawful bounds on its NGA Section 7(e) conditioning authority*.

Section 7(e) of the NGA states that in granting certificates: "The Commission shall have the power to attach to the issuance of the

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17/ *Cf. Electricity Consumers Resource Council* v. *FERC*, 747 F.2d 151 (D.C. Cir. 1984)(rejecting use of marginal cost pricing because of lack of substantial evidence). INGAA recognizes the obvious benefits that flow from healthy competition. But competition is not the only relevant consideration, as recognized by the D.C. Circuit in *Farmers Union Central Exchange, Inc.* v. *FERC*, 734 F.2d 1486 (D.C. Cir.), *cert. denied* 105 S.Ct. 507 1984) (rejecting FERC's attempt to set "just and reasonable" rates for oil pipelines by reliance on market forces). *See also*, *Consumer Federation of America* v. *F.P.C.*, 515 F.2d 347 (D.C. Cir.), *cert. denied* 423 U.S. 906 (1975); and *Moss* v. *F.P.C.*, 502 F.2d 461 (D.C. Cir. 1974), *cert. denied* 422 U.S. 1020 ("'just and reasonable' rates may not be determined solely and conclusively upon the basis of market or contract prices."). *Id.* at 466. See generally remarks of Honorable Patricia M. Wald, to the Institute of Public Utilities (December 3, 1984)(See Appendix).

certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require." The Commission has invoked this admittedly broad conditioning authority, see discussion *supra* at 7, *et seq.*) in attaching the contract abrogation rights to all certificates issued under the new transportation program.

In the discussion, of the Commission's broad conditioning pwer, *supra*, we demonstrated the statutory and judicial authority that supports the Commission conditioning producer access to the new the new transportation program on contract relief, e.g., take-or-pay. In this connection we showed that the Commission can simply deny issuance of a certificate unless certain reasonable conditions are met, and, it makes no difference that the party for whom the transportation is undertaken is not subject to the Commission's statutory authority, e.g., a direct sales customer or, in this case, a producer. Now we shall show that there are indeed limits on the Commission's conditioning authority and why, absent specific factual findings required by the Natural Gas Act, contracts between pipelines and their sales customers cannot be abrogated in the manner chosen by the Commission. There is strong legal precedent in support of our position that reduction and conversion as proposed by the Commission are unlawful.

In *Panhandle Eastern Pipe Line Co*. v. *FERC*, 613 F.2d 1120 (D.C. Cir. 1979), *cert*. *denied* 449 U.S. 889 (1980), the Commission had conditioned a transportation certificate by requiring that revenues from the transportation service be credited to the rates charged the pipeline's sales customers. On appeal, the D.C. Circuit held that *the Commission's "conditioning power does not extend to adjusting previously approved rates* for services not before the Commission in the relevant certificate proceeding." 613 F.2d at 1129 (emphasis added). The Court in Panhandle gave three reasons for its holding. First, "the more expansive holding [of the Commission] would effectively emasculate the role of Section 5 in the ratemaking scheme. Second, interpreting the conditioning power to allow adjustment of previously approved rates eliminates the protection of rate stability called for by the NGA and promotes regulatory lag. Third, the broad interpretation of Section 5 used by the Commission would allow "circumvention of [S]ection 5 requirements of a hearing and specific findings as to justness and reasonableness of rates." 613 F.2d at 1130.

In all three respects just described, Order No. 436, like the Commission's order in the Panhandle case, is unlawful.

First, as in Panhandle, the Commission in Order No. 436 is "emasculating" Section 5 by using its certificate conditioning power to adjust previously approved rates. In Panhandle, this "emasculation" resulted from the fact that, given the Commission's broad construction of its Section 7(e) authority, "there will be no need for the Commission to use Section 5 so long as pipelines continue requesting new certificates." 613 F.2d at 1129. But the certificates they will be seeking under Order No. 436, unlike those in Panhandle, are self-implementing arrangements. Hence, the emasculation of Section 5 will be accomplished here much more quickly and less noticeably than the "emasculation" feared in Panhandle. Therefore, the need for reconsideration is that much more compelling.

Second, the adjustment of previously approved rates will risk substantial rate instability. This will come about from granting permission to existing customers to reduce or to convert their sales contract demand into certified transportation rights. Indeed, the regulations promulgated by the Commission require rate filings to correspond to contract demand reductions or conversions. Predictably, rates to the consumers remaining on the system will increase by virtue of there being fewer total sales customers left on the system.18/ The rule thus is detrimental to consumers and also destabilizes rate certainty because there is no way of controlling the extent of conversions or reductions.

Third, in the Final Rule, the Commission has developed a mechanism whereby it can circumvent the Section 5 requirements of a hearing and specific findings as to the justness and reasonableness of existing rates. Indeed, the Commission in Order No. 436 failed to make any findings under Section 5 to support its use of forced rate adjustments. Hence the Commission acted without even the pretense of complying with the D.C. Circuit's decision in *Panhandle*. What may be worse, however, is that because the rate adjustments are likely to be rate *increases* to existing customers, the Commission has violated NGA Section 5(a) in other respects as well. This is so because Section 5(a) prohibits the Commission from ordering a pipeline to increase its rates. 15 U.S.C. Sec. 717(d)(a).19/

18/ The reservation charges allowed by Order No. 436 for conversions will not make up for lost revenues associated with demand-related costs for customers that have reduced service.

19/ If, notwithstanding the foregoing, the Commission is resolute in going forward with the unlawful use of its conditioning authority for reduction/conversion rights, INGAA respectfully recommends that pipelines at least be provided with the right to make appropriate adjustments, including abandonment, in their service agreements when a customer does reduce or convert. Additionally, INGAA recommends that reducing or converting customers not be relieved of their responsibility for fixed costs relating to the service they have reduced or converted. The reservation charge for firm transportation service should be made equal to the fixed costs previously paid by the reducing or converting customer. Finally, the 60 day notice period on conversions should be deleted and as recommended in footnote 14, *supra*, notice of conversion given by all at the same time each year, effective 9 months later.

G. The Final Rule will not promote the efficient use of pipeline capacity and will interfere with pipelines' control over their own operations.

This fact has already been described generally with regard to the "first-come, first-served" method of capacity utilization. But further examples abound:

(a) Efficient capacity utilization is prevented by the likely possibility of firm sales customers retaining their right to firm sales capacity yet using that already dedicated capacity for the transportation of interruptible load. Such an occurrence can only worsen existing pipeline take-or-pay exposure.

(b) The 60 day notice on conversions will be very disruptive of supply planning. A greater uniform lead time is necessary if pipelines are to operate efficiently and in their customers' best interests. INGAA recommends that a 9 month notice period is appropriate with notice by all customers required at the same time.

(c) In the Final Rule, the Commission seems to assume that pipelines have the flexibility to provide transportation service upon demand at any place along their system. But pipelines were not built and do not operate in this way. In fact, the effect of Order No. 436 may be to idle capacity at either end of a line because a customer unexpectedly demands capacity in the middle of the line. Clearly, such transportation is not in the public convenience and necessity. Moreover, it is unlawful and arbitrary and capricious because it does not address individual pipeline configurations.

H. Block Billing.

The Commission has "re-noticed" its proposal for a block billing mechanism. Accordingly, we will reserve our comments for the supplementary filing due on November 18, 1985. We do observe, however, that as with the promise of take-or-pay relief in the NOPR, the Final Rule issued herein is basically an incomplete document because, by the Commission's own admission, the Rule will not provide its supposed competitive benefits unless all parts of the original proposal are adopted in some form.

VI.

CONCLUSION

For the foregoing reasons, INGAA respectfully requests that the Commission grant rehearing of Order No. 436 and adopt the recommended changes to said Order proposed herein.

Respectfully submitted,

Interstate Natural Gas Association
of America

By__________________________
John H. Cheatham, III
Edward B. Myers

November 8, 1985
Washington, D. C.

REMARKS OF

CIRCUIT JUDGE PATRICIA M. WALD

TO THE

INSTITUTE OF PUBLIC UTILITIES

* * * *

Convention Center

Williamsburg, Virginia

Monday, December 3, 1984

DEREGULATION IN THE COURTS

I have been on the Court of Appeals for the District of Columbia Circuit for five and one-half years. In that time I have seen a dramatic change in the kind of regulatory cases we review, a change that signals a need for courts, agencies, but perhaps most of all Congress, to think again about how our "collaborative partnership" ought to work in the regulatory area. Four years of aggressive deregulation have surfaced a myriad of legal issues about the appropriate standard of judicial review for regulation and deregulation cases. They have also made us think again about the tasks we are faced with, our competence to fulfill them, and our commitment to preserve the integrity of the review process Congress set up in its regulatory laws. This may seem like navel-gazing for a court that has been hearing one out of four federal regulatory appeals in the nation for many years; such appeals make up one-half to three-fourths of our docket. Yet, courts reviewing today's big deregulation cases are operating in a context unique in our history, and many of us feel uneasy, unsure, groping at times as to where the lines should properly be drawn between ourselves, the agencies, and Congress. If Congress wants deregulation to continue at its present pace or even accelerate, then it is my opinion Congress ought to step back and reassess its role in directing the deregulatory process. Often we are working with a 40 year old Administrative Procedure

Act or an even more ancient enabling act, drafted by a New Deal or turn-of-the-century trust-busting Congress. At the same time we are dealing with an extraordinarily committed and energized contemporary agency leadership, who often view the courts as a major obstacle to attaining what they interpret as the mandate of the ballot box. Our court has even been—I think unfairly—compared to the nine old men of President Roosevelt's era, standing in the way of the democratic process. There is, I submit, a major difference between striking down congressional enactments as unconstitutional--as the Court did back in the 30s—and interpreting congressional enactments as requiring agencies to do certain things, as our court is now doing. But there undoubtedly is an increasing tension in relationships between agencies and courts in the deregulation era. Today I'd like to examine some of the reasons why.

I.

Let me start off by briefly tracing the traditional notions of what judicial review of agency action is about. Most would agree that the courts' basic function is to insure that the agency has complied with the statute, and done what Congress intended it to do. This, of course, is a vastly oversimplified definition, because we spend dozens or even hundreds of pages scouring through what one commentator has called the ash cans of the legislative process looking for Congress' intent. Then, often when we find it had no explicit intent about the way a particular provision should be implemented, we spend an equal amount of time deciding under the Administrative Procedure Act whether what the agency did was "arbitrary and capricious," "unreasonable," or without "substantial evidence" in the record to support it. There have been some 35 years of judicial gloss on what all of these terms mean. But I still think the best definition was that given by Judge Leventhal: A reviewing court "must study the record attentively, even the evidence on technical and specialist matters, to penetrate to the underlying decision of the agency, to satisfy itself that the agency has exercised a reasoned discretion with reasons that do not deviate from or ignore the ascertainable legislative intent." This is the so-called "hard look" doctrine of judicial review.

Judicial review, even in the pro-regulatory era, has not been without its critics. Frustrated litigants cited delays, remands for technical errors, undue emphasis on legalisms and adversariness. The law teachers claimed judicial review generated the wrong incentives for agencies, destroyed candid decisionmaking, required agencies to make factual findings that belied the real uncertainties, and motivated agencies to set their agendas with judicial review in mind. Most cutting, they said, too often we did not really understand the technical regulatory issues before us. We exhibited woeful ignorance of scientific norms and principles that underlie technical analysis. We made too vague pronouncements in the form of orders, such as "prevent significant deterioration of air quality." We insisted on "yes or no" answers to regulatory questions when all that is available was "more or less." We gave too much emphasis to legislative history which everyone knows is cooked up by activist subcommittee members and their staffs in conjunction with lobbyists in corridors at midnight on the eve of adjournment. On the other hand, to others judicial review was a last bastion against runaway bureaucracy, given the haphazard nature of congressional oversight. Indeed, as the terms of their delegated powers from Congress grew vaguer and the amount of discretion accorded the agencies grew greater, and the theoretical checks of legislative vetoes and budget resolutions became increasingly remote, the judicial watchdog function assumed even more significant proportions.

Over the years, the courts have woven formulaic webs to keep irrepressible agency decisions within bounds. Agencies must give adequate explanations for what they did, base their actions on a record, available to all, expose their evidence to comment by others, answer the important comments, avoid secret exchanges with interested parties. All salient factors must be looked at and at least the major realistic alternatives assessed. The amount of deference accorded an agency will vary with how longstanding or consistent its present practice is, whether it is interpreting its own statute or one of a more general application, whether it is acting pursuant to an express or implied delegation from the legislature, and how careful a process it has gone through to arrive at its conclusion, etc, etc.

The Supreme Court's recent decision in *State Farm Mutual* (the "*Airbags*" case), suggests we were not all wrong. There the high Court described the judicial review function under the Administrative Procedure Act's "arbitrary and capricious" standard as follows:

> Normally an agency would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. The reviewing court should not attempt itself to make up for such deficiencies: We may not supply a reasoned basis for the agency action that the agency itself has not given.

A few years earlier the Court had sternly rebuked us for imposing on agency rulemaking additional procedural rules, such as cross-examination, that were not contained in the APA (Vermont Yankee I), but now it seemed to be approving a more probing review of the substance or rationality of an agency decision. In fact, in State Farm it expressly rejected an argument that its Vermont Yankee decision could be invoked "as though it were a talisman under which any agency decision is by definition unimpeachable."

II.

Why then are we now so concerned about our role in reviewing deregulation decisions by the agencies? My colleague, Judge Harry Edwards, identified one difference:

> After years of reviewing agency actions imposing regulations judges suddenly have had to adopt a new mindset and review decisions to move in the opposite direction.

He is right. It does require a different mindset to review agency inaction than agency action. For decades our task was to insure that agencies were not overstepping their statutory limits, usurping power and authority Congress did not want them to have, leaning too heavily on the regulated or denying them their rights. Now we are besieged with plaints that the agencies won't use the power they have, won't do the critical balancing of interests Congress told them to, won't monitor the market or protect the weak from the strong. The kind of justification the agency relies on to withdraw from the field is quite different from what it used when it plunged in. Presumably, agencies were set up to do something, to accomplish some goal, to perform some task; in olden times they pointed to their statutory authority to take a particular action and told us how that action could reasonably be expected to accomplish the statutory goal better than other obvious alternatives. Now, however, in reversing course, they must point to authority for not taking particular actions, and show how inaction, or in most cases, deferring to market forces, will accomplish the statutory goal just as well or better. It is often relatively easy to show why repeal of an old rule is reasonable; advances in knowledge or technology may have rendered it obsolete; experience may have shown that it reflected an erroneous estimate of costs and benefits, or it may have created unanticipated dangers or harms. But no action is not the only alternative to bad action: a different and better kind of action may be more logical, especially under a regulatory statute. As it is, however, "broad and virtually standardless delegations of power to administrative agencies, limited simply by such amorphous terms as 'just and reasonable' and 'public interest, convenience and necessity' are currently being utilized to justify the rescission of regulations fashioned over the years to meet those very same standards." That does, indeed, require a resetting of judicial compasses.

In most cases, the justification for deregulatory actions is based almost entirely on economic theory—predictions of what will happen if regulatory constraints are removed, and market forces are allowed to operate. In most cases, to be sure, there is little experience with an unregulated market to draw on. Courts are, nonetheless, faced repeatedly with the basic question of how much deference we should give to an agency's economic predictions of what will happen based on a particular school of economic theory and what kind of empirical data we should require from the agency to assure ourselves the theory really is applicable to the situation before us or is working out in real life according to its textbook terms.

There are two problems these theoretical economic analyses raise for judges: one is learning to understand, manipulate and occasionally see through the economist's jargon. The second is deciding how much weight to give the theories in deciding whether the agency has provided a reasoned justification for deregulation.

A year or so ago, I wrote about some of the problems courts face reviewing economic analyses. In a nutshell, we hear a lot of cases (several hundred a year); our learning time for each one is short; the lawyers who write the briefs must themselves understand the analyses in order to present them coherently and they do not always do so—we get our analyses filtered through factfinders below and advocates above. We are not allowed to supplement our limited capabilities or education by consulting outside neutral experts—we must rely on the combined wisdom, or lack thereof, of our colleagues and law clerks and the written record. There is a danger that unless one works very hard at it and focuses on the key questions that a reasonably educated layman would ask, it is easy to fall prey to what some refer to as "judicial math block" and take the attitude, "If it is too complicated for me to understand, the agency must be right."

We have to remind ourselves that economic theories are buried in those models and it is our job to make sure that the agency has justified the assumptions that the model is operating on, and that the results of the simulations flow logically from those assumptions. Logic and reasoning are judicial turf, not to be conceded to economists and computer specialists. But the going is often tough. Fred Rowe describes what he calls the "Faustian Pact Between Law and Economics" as follows: "If they wish, judges can close their eyes, inhale a model, and become prophets swallowing the whale of ideology whole. . . . The upshot is a vendomat jurisprudence: a model is plunked in, a legal result pops out."

A second dilemma for judges is how far theory can take an agency. Certainly in probing which economic theory to use to predict results or market behavior, agencies deserve some deference as to what school of economics—Chicago, MIT, Keynes or Adam Smith—they follow. It goes with the political territory Specifically, the Efficiency Model—or the self-correcting market—is the most popular theory these days: "the market ensures efficiencies and cures inefficiency if meddling governments keep out." Courts have traditionally afforded agencies a fair amount of leeway when it comes to proving how experimental policies will work out. Nonetheless, many of us feel that until Congress tells us differently, we have a right to demand that the factual premises of the economic theories put forth by the agencies are accurate in the case before us, and that the predicted results according to the theories are not in outright conflict with the facts placed before us.

I used to read my kids a Dr. Seuss fable, about Yertle the King of the Turtles, who surveyed his empire standing on a hill made up of the backs of other turtles, until one small turtle revolted:

Then again, from below, in the great heavy stack,
Came a groan from that plain little turtle named Mack.
"Your Majesty, please . . . I don't like to complain,
But down here below, we are feeling great pain.
I know, up on top you are seeing great sights,
But down at the bottom we, too, should have rights.
We turtles can't stand it. Our shells will all crack!"

One gets the feeling sometimes the theorists, like Yertle, are seeing "great sights" at the expense of the backs of the little Macks out there.

Across the deregulatory spectrum, there is a definite move to redefine and diminish the concept of what is a public utility or common carrier which, if it continues apace, may leave precious little for you to talk about at these meetings. Once a company, a system, or an industry no longer comes within the definition of a public utility, the legitimacy of regulation—for any goal or public interest—tends to dissipate. And the justification for not calling it one is almost invariably that, left to itself, the market is a better allocator of costs and benefits as far as the ultimate consumer is concerned. Few if any other values enter the equation.

III.

I am going to discuss a few recent cases in our circuit as illustrative of this ongoing tug-of-war between judges striving to apply the traditional administrative law doctrines to this new breed of case and agencies committed to the new economics of the self-correcting marketplace: they involve oil pipeline regulation, railroad regulation, and communications, the FERC, the ICC and the FCC. You can see I play no favorites.

A. The Problem of Pouring New Economic Theory Into Old Statutes

One "hot" issue in deregulation law is how far the agencies can go it on their own—how much they can reinterpret the statutes under which they operate so as to minimize governmental intervention and maximize free market forces. Obviously the answer will differ with the language of the statute, what its drafters and sponsors said during passage, the "mood" of Congress when it was enacted, the goals it laid down, and the specificity of the ends and means it set out for accomplishing them.

In Farmers Union Central Exchange v. FERC (a writ of certiorari is now pending in the Supreme Court), we reversed a FERC order specifying a new kind of ratemaking methodology for oil pipelines. The Commission, in a 346-page opinion, "the longest and most elaborate decision" in its history, said that oil pipeline regulation should henceforth serve only as a cap on "egregious" price exploitation, "gross overreaching," or "unconscionable gouging," and that competitive market forces should be relied upon principally to assure rate levels within a zone of "commercial reasonableness." The Commission also revised its rate of return methodology (as well as its rate base formula) so that the maximum rate levels would represent ceilings "seldom reached in actual practice." FERC said competition (actual and potential) is a far more potent force in the oil pipeline industry than in the others—yours—it regulates. FERC reasoned that the Lodge Amendment to the Hepburn Act in 1906 which extended ICC jurisdiction to cover oil pipelines was enacted in a "climate of opinion" that focused on the atrocious behavior of Standard Oil Company, the industrial archvillain of that time, which had a nasty habit of cutting off competitors' access to pipelines by charging them extraordinarily high rates. It was in that historical context--FERC said--the Lodge Amendment required that pipelines' prices be "just and reasonable." That term—FERC continued—did not mean the same thing as applied to pipeline pricing as it later came to mean in utility pricing. The Congress intended not "public utility reasonableness" (cost plus reasonable return), but "commercial reasonableness" (restraint of "gross overreaching and unconscionable gouging") There need not be a necessary connection between revenue recoveries and cost of service. FERC also argued that the oil pipeline market had become more competitive since 1906. No oil company was wholly self-sufficient anymore—they all had to use each other's facilities. Pipeline prices had also declined precipitously over the years. The current threat, FERC declared, is not overpricing to consumers but underinvestment in needed oil pipelines, so it was "best to err on the side of liberality . . . the dangers of giving too little vastly outweigh those of giving too much."

On all these grounds, the Commission opted for a "'real entrepreneurial rate of return,'" designed only to provide "a cap on gross abuse." A pipeline could pick between 8 different measures for its "entrepreneurial" rate of return. It could choose nominal r.o.rs. on book equity over a one or five year period for the oil industry generally, American industry generally, or the parent company (excluding pipelines), or it could opt for total returns on a diversified stock portfolio over the past five years or over "the long run" (25 or 50 years or more). Quite a market basket. Its overall result, FERC admitted, would be "handsome rate base writeups," followed by "creamy returns on book equity"; the "ceilings . . . will seldom be reached in actual practice."

In our review of the FERC decision, we began with the pertinent section of the Interstate Commerce Act which said oil pipeline rates must be "just and reasonable." We found that FERC in this case had established maximum rate ceilings at a level far above the "zone of reasonableness" in the generally accepted cost-based sense of the word. But more important, it had not been specific enough in setting out how "noncost" factors like the need to stimulate additional investment related to its rate decision.

We admitted the term "zone of reasonableness" is inherently "not very precise." But courts in the past have generally launched their inquiry by looking at costs. Noncost factors could legitimate a departure from that approach. But mere invocation of a noncost factor would not be enough: "when FERC chooses to refer to noncost factors in ratesetting, it must specify the nature of the relevant noncost factor and offer a reasoned explanation of how the factor justifies the resulting rates." It must make a reasoned connection between the special factor and the particular rate methodology it adopts. In this case, FERC failed to forecast or otherwise estimate the dimensions of the need for additional pipeline capacity; it did not even attempt to calibrate the relationship between increased rates and the attraction of new capital. It was not enough to say "everyone agrees that the nation needs and will need more pipeline plant." In sum, changing circumstances may justify a new approach to the determination of just and reasonable rates, but to allow FERC to pour any meaning it wants into the term "just and reasonable," would mean the congressional delegation of authority to the ratesetting agency was total and without statutory-based standards. We found no indication Congress meant to do that. In 1906—we said—Congress intended to submit oil pipelines to the same general ratemaking principles that applied to other common carriers. That meant more than a ban on prohibitive pricing; it meant rules that would permit the carriers to earn a fair return while protecting the shippers and the public from economic harm. Even if the contemporary evil Congress addressed was prohibitive pricing, the solution it devised was broader and required that oil pipeline rates be "just and reasonable."

Critically, we found FERC's reliance on competition and market forces to keep prices down, to be undocumented. Since market imperfection was the central rationale for the imposition of rate regulation, "just and reasonable" rates could not logically be conclusively determined by reference solely to the market place:

> FERC's methodology exposes a range of permissible prices that would exceed the zone of reasonableness by definition, unless competition in the oil pipeline market drives the actual prices back down into the zone. But nothing in the regulatory scheme itself acts as a monitor to see if this occurs or to check rates if it does not. That is the fundamental flaw in the Commission's scheme.

Farmers Union illustrates a recurrent type of deregulation case where an agency seeks to self-deregulate in accordance with changing times and a new philosophy, but within the bounds of a very old statute. In fact, the Administration had, even before our opinion came down, been supporting a change in the statute which would have explicitly allowed deregulation of oil pipelines. In the absence of amendment or repeal, however, how drastically can an agency deviate from past practices and still stay within its statutory authority? Where past Congresses have repudiated the market as a regulator and created agencies—for good or for ill—to supplement or supplant the market, can courts endorse wholesale withdrawal by the agencies from the regulatory arena in favor of the free market? One commentator has suggested that Congress in the future should either set down clear goals for agencies, instead of vague phrases like "just and reasonable" or "in the public interest," or come right out and let the agencies choose their own values to implement—provided, of course, the latter could pass the constitutional delegation test.

Law reviews and even one Supreme Court Justice's opinion has talked about reviving the nondelegation doctrine to require Congress to accompany these huge delegations of quasi-legislative powers with some clearer standards about implementation I personally think the deregulation cases have pointed up the need for Congress to give more direct guidance on how far and under what kind of showing it wants the agency to deregulate. We—the courts—are supposed to be Congress' agent in monitoring compliance with its dictates; the vaguer it is, the more our analyses are likely to differ from the agency's as to when the proper showing has been made—the relevant factors considered—for drastic deregulation.

Executive agencies are in large part political animals, reactive to changing political climates, new signals and even mandates from the White House changing personnel every four years. Congresses, which are unabashedly political, come and go every two years with different goals, philosophies and priorities. Courts are nonpolitical with judges of lifetime tenure. Inevitably, our constitutional scheme means that the courts are put in the position of holding down agencies' actions to the letter of statutes with which present Congresses may have become disenchanted, but haven't gotten around to or can't muster the votes to change. Perhaps interest in the much-maligned sunset concept needs to be revived.

Farmers Union also incorporates a "monitoring" theme found in several of our deregulation cases. In general, a court feels much more comfortable about accepting predictions of what the market will do if it knows that the agency will move in if the market does not behave as predicted, rather than stand back and say, "Tsk, tsk, we guessed wrong." Courts have always been fairly tolerant of the need for agencies to experiment with new ways of doing things, even though uncertainties exist. But they have also been intolerant of using the experimental approach indefinitely without regard for the actual experience the experiment is generating.

The underlying thrust of FERC's oil pipeline ratemaking was that regulatory intervention should be saved for exotic cases of gross abuse and gouging, not used as a standard-setter for the usual case. A ratemaking method that is so innovative it cannot be rationalized under any kind of generally accepted ratemaking principles and must be justified only under a notion that only outright gouging need be protected against, comes close to a general exemption from statutory regulation. We did not believe Congress, which had not changed the basic statute since 1906, had authorized that kind of implementation. In our view, it was Congress' call, not ours, or the agency's, if so fundamentally a different set of plays was to govern this regulatory game.

B. Deregulating In Partnership With Congress Under the Watchful Eye of the Court

In some areas, unlike oil pipelines, Congress has spoken in favor of deregulation, but the language in which it has spoken has not always made the courts' job easier. In 1980, Congress passed the so-called Staggers Act, four years after an earlier but less farreaching deregulation act—the 4Rs. Both laws aimed at reducing regulatory interference with railroad pricing, and helping railroads to achieve adequate revenues.

Under the Staggers Act, there is no question that widescale deregulation was contemplated. The issue in the many post-Staggers cases we review is whether the ICC has fulfilled the statutory conditions required for deregulating and taken account of all the relevant factors or interests Congress laid down in its National Transportation Policy Act. In addition, the cases usually involve questions of whether the facts in the record bear out the economic theory justifications forwarded to support deregulation. One of our recent transportation deregulation cases, Coal Exporters v. United States, reflected both problems—whether the ICC had taken account of the relevant factors in the law, and whether the facts fitted its theory of why deregulation was justified. The agency utilized its broadly worded exemption power under section 10505 of the National Transportation Policy Act to exempt from rate regulation all transportation of coal destined for export through United States ports. Eastern coal producers and shippers challenged the action, claiming it violated several goals laid down in the Transportation Act, principally that the Commission assure "reasonable rates [for shippers] in the absence of effective competition" where "[the railroads] revenues exceed the amount necessary to maintain the rail system and attract capital." The point-counterpoint ricochet between the Commission's theory and the facts recounted in the opinion illustrate both judicial persistence and insistence that an economic theory not be advanced in a vacuum—that there be some objective evidence that the theory fits the facts and will work out according to its own logic in real world terms.

In Coal Exporters, the Commission argued that maximum price regulation was unnecessary for railroads carrying export coal because of the constraints of world competition among coal exporting countries, regional competition in our own country among coal producers, and intermodal competition from trucks, barges, or pipelines. The sparring match went like this:

The ICC argued:

> The United States cannot raise its coal prices without lowering its market share.

But, the court said:

> The Commission's opinion contains no economic analysis of exactly how sensitive the world market would be to any United States price increase—the ICC's discussion was in general and largely theoretical terms.

And anyway: .

> Although a world price cap for delivered United States coal might mean that foreign consumers will not have to pay a higher price, it does not assure that the division of revenues between the railroads and United States shippers will be a reasonable one.

The ICC argued:

> Different rail-carriers transport the export coal of different regions—competition between those regions would act as a restraint on railroad power to raise prices too high.

But, the court found:

> Competition between coal regions for the European market was in fact minimal due to distance from ports, and quality of different coals mined in different regions.

The ICC argued:

> Competition between railroads would provide significant restraints; transhippers who buy from many producers for sale to foreign customers could bargain with the carriers on rates.

But, the court found:

> Ninety-five percent of the mines are captive to the railroads that serve them. Transhippers blend coal from many mines but their component coals are not fungible and must be available and not already committed, so they are not in a position to bargain hard with the railroads.

The ICC argued:

> Potential intermodal competition by trucks, barges, and pipelines would restrain railroads from charging too high prices.

But, the court found:

> Only 13% of all coal production is transported by truck (less than 1% of coal export); 17% is transported by barge. But most barge-carried coal gets to the barges by rail; moreover, barge-transported coal is high sulfur midwestern, which offers little competition to lower sulfur eastern coal; truck shipment is not economically practical for large shipments or long distances.

The gap between theory and fact proved too wide in Coal Exporters for the court to accept. The court also based its decision on a finding that the Commission ignored the statutory command to assure that in cases where there was no effective competition and the railroad was making adequate revenues, the rates would be reasonable. It erroneously assumed that so long as coal shippers are not forced to reduce production (because of failure to receive costs including capital) any rate is "reasonable" and not an "abuse of market power."

The court said the Commission could not ignore the division of rates between monopolistic carriers and captive shippers, under the statute. The ICC's exemption would permit railroads to use their monopoly over shippers to appropriate to themselves an unreasonable portion of profits, thereby defying the NTPA's bar against unreasonable rates in the absence of effective competition when revenues were adequate.

In Coal Exporters the court thought the Commission's economic theory did not square with the facts; that its predictions didn't flow from those facts that were knowable, even given tolerance for the uncertainties of predictions as to how the market will behave. The opinion also suggests economic theory backed by experience or empirical data will commend itself more to a court than pure theory. Whether or not you agree with Coal Exporters, I am sure you see the added complexity and conceptualization required of a court in deregulation cases built so heavily on economic theory and predictions.

In Coal Exporters, too, it is interesting how often the dissenting ICC Commissioner is cited, over 50 times to my count. Although the prevailing notion is that a divided Commission's decision is entitled to as much weight from a court as a unanimous one, there is little question that a well-reasoned dissent is carefully read and often proves persuasive to a court in doubt. Intuitively, if "expertise" is divided, it tends to command less deference on judicial review.

The use of theories, predictions, and models in lieu of objective or empirical data places a decided strain on the "substantial evidence" requirement of APA review. Even in its deregulating statutes, Congress still speaks in terms of agency "findings" which traditionally have been based on more tangible and traditional evidence. The wholesale replacement of theory for fact suggests another look by Congress at the APA and its judicial gloss may be in order--to define more precisely what differential or deferential standard we should use on review for facts stated, for predictions made, for theories of market behavior put forth as justification for agency deregulatory decisions.

C. The FCC's Success Story in Deregulation Reviews

In contrast to the spotty record of ICC and FERC deregulation in the courts, the FCC has had a steady string of victories. I wish I could tell you why. I can only guess. It is still operating under an old statute written in the pro-regulatory 1930s with only a vague "in the public interest" criteria to guide the agency's actions. Yet, it has embarked on dramatic and far-reaching deregulation of radio program controls, many of which were erected, by our court, as late as the 1970s, under the very same "public interest" rubric.

The FCC's main argument for free market control was "changed circumstances"—the vastly larger numbers of stations now than in 1935, the equivalency of AM and FM, the increasing tendency of radio stations to specialize. Lots of specialized stations equals diversity, the same diversity formerly sought through regulation of individual stations. Advertisers want listeners to buy their products; therefore they have the incentive to put on the programs people want. Even news is profitable these days.

This rationale passed muster in our court, with one exception. I believe three unique factors are present in airwave deregulation, that help to explain why. First, in 1981, the Supreme Court, in FCC v. WNCN Listeners

Guild, reversed our court's en banc opinion which in turn had overruled the FCC's Policy Statement that henceforth all entertainment program format changes would be left to the market, and such format change would not constitute a material element in a renewal application.

The FCC's position, accepted by the Supreme Court, was that: (1) the Communications Act did not, by its language or history, require this regulation of programming content; (2) the marketplace would more efficiently produce and preserve diversity in program offerings; and (3) the Commission should not be burdened with making the subjective evaluations necessary to determining which formats should and should not be preserved.

The Court began its analysis with the assertion that "the Act does not define the term 'public interest, convenience and necessity'" and that "the public-interest standard of the Act [is] 'a supple instrument for the exercise of discretion by the expert body which Congress has charged to carry out its legislative policy.'" The Court went on to emphasize the broad discretion the Act gives the FCC not only to promote the public interest, but to determine what the public interest is. The Act does not preclude the FCC from reviewing entertainment formats, but neither does it require the FCC to regulate programming. The Commission, therefore, was within its power in deciding that the marketplace was a better regulator of programming options, serving the public interest by promoting diversity. The market, according to the FCC, "would serve the public interest as well or better [than regulation] by responding more quickly to changing preferences and by inviting experimentation with new types of programming." In effect, "public interest" becomes "what the public is interested in," rather than "what is in the public's interest." *WNCN* also made a great deal of the FCC's reliance on citizen complaints as the most accurate and least inconvenient way to monitor programming. After *WNCN*, it would have taken a lot of hudzpah for a lower court to say a FCC deregulation attempt in this area was arbitrary or capricious.

Predictably and shortly after *WNCN*, in a giant deregulatory leap, the FCC proposed a simplified renewal application procedure for radio and television licenses. Known as "postcard renewal," the procedure eliminated the old, more comprehensive renewal applications, which required information about stations' programming and compliance with FCC regulations, and replaced them with a five-question form. The postcard simply asked a station for location information and whether it was complying with basic operational FCC regulations. The new form did not require any information about a licensee's non-entertainment programming. The question presented to our court was whether the FCC could adequately assess a station's performance of its obligations, based on such limited information.

Upholding the FCC's new approach, our court, in *Black Citizens for a Fair Media* v. *FCC*, invoked the "supple instrument" language relied on by the Supreme Court in *WNCN*. More specifically, Judge Bork stated that, because the Act does not *require* the Commission to conduct detailed reviews of station programming when considering renewal applications, the FCC is free to alter its past practices when it decides that the public interest is equally well-served by a less-burdensome process.

By its new policy the FCC was not abandoning its duty to ensure that licensees were operating in the public interest, according to the court. Basic (non-programming) information is still provided in the renewal form. More importantly, "the FCC will have the input of the public," which would monitor a station's programming and have access to its public file.

> This is in many ways the most critical information, as the Commission has "found that the best vehicle for bringing violations to [its] attention has been public participation in [its] processes through petitions to deny, informal objections, and complaints."

Pubic input works two ways: --complaints notify the FCC of violations, and "public silence supports an inference that a licensee has been complying with FCC policies." Further, relying on the public to monitor possible violations is "especially warranted in an era of limited resources," when the FCC has so much else to do.

A companion case, United Church III, considered, and to a large degree upheld, the FCC's plan to deregulate commercial radio operations. In UCC III, the FCC proposed eliminating the non-entertainment program guidelines that affected the way in which a renewal application was reviewed. Under previous FCC policy, if a station's non-entertainment programming fell below a certain amount or its commercial time went above a certain amount, its renewal application must be considered by the full Commission, instead of by the Broadcast Bureau. This was sufficient incentive for most stations to keep their non-entertainment programming at the specified level. The new FCC policy removed the two-tiered review system and required only that a broadcast licensee's programs be generally responsive to issues of interest to its community.

The court did balk at one aspect of radio deregulation. The FCC had proposed to drop the requirement that stations maintain programming logs and keep them open for public inspection. But the court said they must keep some public record if the citizen monitoring theory was to have any substance. Once the non-entertainment programming requirement had been reduced to a non-specific directive to respond to issues of importance to the community, it would not be enough for someone trying to evaluate whether that obligation had been met simply to look at a summary of "issues/responses" prepared by the station for its public files. More detail was necessary. The court did not require the FCC to insist on maintainance of station program logs exactly as it had previously but it did direct the FCC to come up with some log-like means to provide the information necessary to evaluate a station's performance. The monitoring theme again.

It is worth noting that while *WNCN* dealt with entertainment programming, *Black Citizens for a Fair Media* v. *FCC* and *United Church of Christ* v. *FCC* involved *non-entertainment* programming. But while *WNCN* involved an elimination of entertainment programming format changes as a factor in license renewals, *Black Media* and *UCC* kept non-entertainment programming as a material factor but drastically reduced the requirements for licensees to show they were doing it.

Aside from the Supreme Court lead, a second possible factor in the FCC's success story is that there has always been a tension in program regulation between the "public interest' and the First Amendment right of station owners to say what they want when they want. A debate over the legitimacy of the "Fairness Doctrine," requiring both sides of important public issues be aired, has been waged since the late 1960s with stalwarts like former Chief Judge Bazelon of our court on the side of nonfairness. Thus the recognition of a continuing constitutional tension in program regulation may well have contributed to a judicial receptivity to program deregulation.

A third factor: everybody is a consumer of radio and television, even judges. They may be among the most important consumers of all since judges as consumers could tell from their own experience that there really was diversity out there in a multitude of channels and programs. This might not be true for every hamlet of the country, but for most medium and large-sized metropolitan areas where judges tend to congregate it certainly was. In short, they could draw on personal and practical experience to evaluate the FCC's theories of how the marketplace would work. And finally—important as it is to our cultural and political life—few of us live or die economically because of what is on the airwaves. Abdicating or deferring—call it as you will—to public clamor as the monitor of its own best interest comes in a context where everyone has a stake in and is capable of making his/her wants and preferences known, and few will perish economically if these wants are not met. In a subtle way, I think that makes a difference as to how courts look at radio and television deregulation.

In any event, courts have appeared readier to accept the market allocation theory in the communications area. In summary, with respect to FCC deregulation of radio programming, three things stand out. First, the commodity concerned was uniquely susceptible to public visibility and comment. Second, the FCC did not remove any of the general substantive criteria for non-entertainment programming, just the proof requirements. A licensee is still supposed to avoid excessive commercials, fulfill some responsibility for informational progrmming, and ascertain the community's desires by some means. But the public has the responsibility of showing that they are not doing it. And third, the Supreme Court led the way in its broad construction of what the FCC could do under the "public interest" rubric in programming.

The FCC, of course, does not regulate only radio and television. It has jurisdiction to regulate or not to regulate, as the case may be, other kinds of telecommunications and data processing. I have neither the time nor the expertise to go into the saga of *Computer I* and *Computer II* today except to make one point. Dramatic changes in technology have required or allowed the FCC to review what constitutes "common carrier" service, which is not defined by the Act even though the Act authorizes regulation of rates charged for such service. The Commission has determined that many telecommunications services are common carrier services for the purpose of the Act because of market conditions and the courts have generally upheld it, on the ground that such evaluation of new technology, and determination of the best way to deal with it, is what the FCC is supposed to do with the elastic powers bestowed upon it by Congress. "In [its action] the Commission took full advantage of its broad powers to serve the public interest by accommodating a new development in the communications industry. . . ." But just as the Commission has the power to create new regulations for new technology, so may it remove old regulations which new developments render unnecessary or illogical.

Common carrier and public utility are not permanent labels. I would expect to see in the next several years attempts at deregulating many more traditional public utility or common carrier services. If or when that happens, it is my fervent hope that you people out there will make our job easier on review by providing us with accurate, understandable facts about how the market is structured, how it is actually operating—in the real world, not just in the textbook or even in the model. "The market" is after all not a real place; it is only a metaphor. You must tell us who will be hurt and who will be helped by new agency policies and how. You must tell us too how this policy fits into any grander regulatory or deregulatory scheme—to give us our bearings in the statute and in the real world. We in turn will try to give you a rational decision in a fast moving and freewheeling deregulatory climate. We stand fall together.

Thank you.

Christa McAuliffe to conduct the world's first lesson from outer space for the benefit of all humanity.

● Mr. **HUMPHREY.** Mr. President, today I join my distinguished colleague Senator RUDMAN in submitting a concurrent resolution congratulating Sharon Christa McAuliffe on being selected as the first teacher in space.

The entire State of New Hampshire is filled with a deep sense of pride in this outstanding woman, who will be the first private citizen to participate in space flight. It is especially significant that the first private citizen in space will be a teacher, as tomorrow's explorers are in the schools of today. A teacher's experience can be a great motivating force for our Nation's youth. Christa's experiences in space will reach much further than her own classroom; they will touch students across the country, and indeed, every one of us.

Space exploration has opened new frontiers for humanity: Christa McAuliffe's flight will open new frontiers for all of us. We all look forward to reading Christa's space journal when she returns from outer space to experience this incredible journey through the senses of a *fellow* private citizen.●

● Mr. **RUDMAN.** Mr. President, it was terrific news and a step in the right direction when President Reagan announced last year that the first private citizen to be launched into orbit on NASA's space shuttle would be a teacher. What better way to highlight the importance our society places upon education.

But, Mr. President, I was particularly pleased when Vice President Bush announced last month that the teacher will be Christa McAuliffe, an enthusiastic and extremely articulate social studies teacher from Concord High School in New Hampshire.

Those of us from New Hampshire are extremely proud of Christa and are anxiously awaiting her trip into space. But we also recognize that Christa will carry with her the hopes and dreams of millions of Americans who have supported our space program and carefully followed the development of the space shuttle. Christa represents the more than 10,000 teachers who applied, representing elementary and secondary schools throughout the United States and its territories, competing for the honor of being the first "teacher in space."

As a space flight participant on a shuttle to be launched next January, Christa will keep a personal journal detailing her experiences in flight which she plans to share with educators from all disciplines throughout the Nation. She will be a guest speaker at national, regional, and State educational workshops and conferences where she will discuss the realities of the trip and offer her perspectives on space technology in terms of politics, science, defense, art, and as an aid to humanity.

In addition to her role as high school teacher, wife, and mother of two young children, Christa is a board member of the New Hampshire Council for the Social Studies, the Junior Service League, a volunteer for a family planning clinic and is active in fundraising for community projects. She represents the best of the American volunteer spirit.

I am very pleased to congratulate Christa McAuliffe on her selection as the first teacher and first private citizen in space and would like to compliment NASA on its fine decision. One need only meet Christa for 1 minute to recognize that NASA made the right choice in selecting this intelligent, accomplished young woman from New Hampshire. Her selection as a member of the space shuttle crew continues our State's long history of contribution to the Nation's space program which began with Alan Shepard's first solo space shot nearly 25 years ago. It also underscores the important role educators have played in our society toward the development of knowledge and understanding, as well as the ability to instill a sense of curiosity and appreciation for learning in our Nation's youth.

On behalf of my colleagues and the entire Nation, I extend congratulations and best wishes to Christa McAuliffe. We all look forward to that momentous day next January when all systems are "go" for liftoff to her exciting venture into space.●

SENATE RESOLUTION 255—CONCERNING THE FEDERAL ENERGY REGULATORY COMMISSION'S VOLUNTARY NATURAL GAS TRANSPORTATION PROGRAM

Mr. **NICKLES** (for himself, Mr. DOMENICI, Mr. DOLE, Mr. BOREN, and Mr. GRAMM) submitted the following resolution; which was referred to the Committee on Energy and Natural Resources:

S. RES. 255

Whereas, due to the complexity, uncertainty, disincentives and problems created by the Federal Energy Regulatory Commission's voluntary natural gas transportation program, established by final rule by FERC Order No. 436, few pipelines are willing or able to participate immediately in the program;

Whereas, most of those pipelines that are currently participating have only committed to participate through December 15, 1985;

Whereas, as a result of pipelines' decisions not to participate, numerous natural gas consumers located throughout the Nation have experienced a discontinuance of natural gas transportation services;

Whereas, as a result of pipelines' decisions not to participate certain natural gas transportation programs have ceased to exist and, as a result, many natural gas producers are being forced to shut in natural gas production due to lack of available transportation;

Whereas, this situation can only be expected to worsen over time due to the expiration of other existing voluntary natural gas transportation programs;

Whereas, all consumers and producers of natural gas must have access to nondiscriminatory transportation in order to provide competition in the natural gas marketplace, and to assure an adequate and reliable supply of natural gas at the lowest possible cost; and

Whereas, producers of natural gas, both independents and majors, must have access to nondiscriminatory transportation in order to be able to make available natural gas to meet market demand, and to insure continued exploration for new natural gas reserves: Now, therefore be it

Resolved by the Senate of the United States, That it is the sense of the Senate that—

(1) the Federal Energy Regulatory Commission should make such changes to the transportation and certificate regulations implemented by Order No. 436, without going beyond their current scope, as may be necessary to remove the disincentives for natural gas pipelines to provide voluntary transportation of natural gas for others;

(2) such changes should be made as soon as possible so as to insure uninterrupted transportation of natural gas to residential, commercial and industrial gas consumers;

(3) until such changes are made, the Federal Energy Regulatory Commission should immediately take such actions as may be necessary to make available on an expedited basis natural gas transportation pursuant to the Natural Gas Act and the Natural Gas Policy Act so as to preclude further disruption in the natural gas marketplace; and

(4) once such changes are made pipelines will participate in the voluntary natural gas transportation program.

SENATE RESOLUTION 256—TO ESTABLISH AN AD HOC COMMITTEE OF THE SENATE

Mr. **DOLE** submitted the following resolution; which was referred to the Committee on Rules and Administration:

S. RES. 256

(1) There is hereby established an Ad Hoc Committee of the Senate consisting of all members of the Senate duly chosen and sworn. The Majority Leader shall designate a chairman and the Minority Leader shall designate a Vice-chairman. A quorum shall consist of 6 members no more than three of which shall be from one party.

(2) The President Pro Tempore of the Senate or his designee is hereby authorized to issue a subpoena to require the attendance of Miroslav Medvid at a hearing before the Ad Hoc Committee to be held at 9:30 a.m. November 12, 1985, in S. 207 of the U.S. Capitol, Washington, D.C. or at such other time or times and places as the chairman of the Ad Hoc Committee shall designate. The Sergeant of Arms, or his designee, is authorized and directed to serve such subpoena forthwith.

(3) The appropriate agencies are requested to assist the Senate in the service of the subpoena referred to in paragraph one and in obtaining the presence of Mr. Miroslav Medvid before the Ad Hoc Committee.

Congress of the United States
House of Representatives
Washington, DC 20515

FOR IMMEDIATE RELEASE
Friday, November 8, 1985

CONTACT: Linda Stuntz, 225-3641
Rick Young, 225-6427

HOUSE LEADERS UNITED ON NATURAL GAS TRANSPORTATION

Today a diverse group of senior House Members introduced a resolution calling on the interstate natural gas pipelines to transport natural gas for all parties on a nondiscriminatory basis.

Natural gas legislation has historically divided Members from consuming and producing states, Democrats and Republicans, and liberals and conservatives. However, recent actions by the interstate pipelines to close off consumer access to competitively priced natural gas and producer access to needed markets has united traditional adversaries.

Although most natural gas is bought, transported, and sold solely by interstate pipeline companies, a small but increasing share of natural gas is being sold by producers directly to consumers with the pipelines merely transporting gas. The D.C. Court found that it was discriminatory for pipelines to transport for only certain customers. In response, the Federal Energy Regulatory Commission issued an extensive order basically allowing the pipelines to decide whether to transport for all customers or transport for none. Most of the pipelines have chosen the latter course.

The shut-off of this burgeoning market means the loss of millions of dollars for already hard pressed domestic industries, such as the steel industry, and unnecessarily high prices for residential consumers. Similarly, the shut-off deprives the depressed natural gas production industry access to the only growing domestic market for natural gas. Independent producers are particularly hard hit.

According to the lead sponsors of the resolution, Congressmen James T. Broyhill (R-N.C.) and Mike Synar (D-Okla.), "the resolution we are introducing today puts the natural gas industry on notice that the Congress believes that the natural gas transportation market should operate in a competitive fashion that benefits both consumers and producers."

Mr. Broyhill is the Ranking Republican on the House Committee on Energy

(more)

and Commerce, while Mr. Synar chairs the Subcommittee on Environment, Energy, and Natural Resources of the House Committee on Government Operations.

Joining the two in co-sponsoring the resolution are House Majority Leader Jim Wright and Minority Leader Robert Michel. Additional co-sponsors are the Chairman of the House Energy and Commerce Committee, John D. Dingell (D-Mich.), as well as the Chairman and Ranking Minority Member of its Subcommittee on Fossil and Synthetic Fuels, Philip R. Sharp (D-Ind.) and William E. Dannemeyer (R-Ca.), respectively. Other co-sponsors are Congressmen Florio (D-N.J.), Ritter (R-Pa.), Tauzin (D-La.), Hall (D-Tex.), Wolpe (D-Mich.), Fields (R-Tex.), Tallon (D-S.C.), Durbin (D-Ill.), Richardson (D-N.M.), Tauke (R-Iowa), Oberstar (D-Minn.), McMillan (R-N.C.), and Bryant (D-Tex.). The text of the resolution follows:

> Whereas consumers of natural gas, large and small, must have access to nondiscriminatory transportation of natural gas in order to encourage competition among suppliers of natural gas and thereby assure the lowest reasonable prices;
>
> Whereas producers of natural gas, particularly independent producers, must have access to nondiscriminatory transportation of natural gas in order to market their gas at fair prices and to continue exploration and production of natural gas; and
>
> Whereas natural gas transportation practices unnecessarily restrict the ability of willing sellers of natural gas to sell gas to willing buyers, resulting in shut-in natural gas and high prices to consumers: Now, therefore, be it:
>
> Resolved, That it is the sense of the House of Representatives that interstate natural gas pipelines should transport natural gas for any person, including residential and commercial users, and should do so on a nondiscriminatory basis.

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas)
Pipelines After Partial)
Wellhead Decontrol)

Docket No. RM85-1-000
(Part D)

COMMENTS OF PAUL R. CARPENTER, INCENTIVES RESEARCH INC., ON FERC NOTICE REQUESTING SUPPLEMENTAL COMMENTS (Issued 10/9/85)

My name is Paul R. Carpenter. My business address is One Kendall Square, Building 200, Cambridge, Massachusetts 02139. I am the Vice President of Incentives Research Incorporated, a firm which provides economic and financial counsel, primarily in the fields of oil and gas regulatory policy and antitrust, to public and private sector clients. A copy of my resume is attached to these comments.

To briefly summarize my educational background and qualifications, I received a PhD in Applied Economics from the Massachusetts Institute of Technology in 1984. My training and research are in the fields of industrial organization, regulation, financial economics and energy resource economics. My prior degrees include a Bachelor of Arts in Economics from Stanford University in 1976, and a Master of Science in Management from MIT's Sloan School of Management in 1978.

My comments below are designed to respond to the Commission's economic analysis of their "block billing" proposal (as contained in the Notice Requesting Supplemental Comments). The focus of these comments will be on the likely effect of block billing on gas consumers and the gas pipeline industry.

I conclude here that the block billing proposal, if implemented, will set forces in motion which will lead to financial distress in the gas pipeline industry. This distress will not be the result of "natural" competitive pressures weeding out inefficient firms, but will instead be largely the result of the historical accident of a given pipeline's gas supply portfolio -- portfolios designed to cope with the regulation-induced shortage conditions of the 1970's and the competitive gas supply bidding conditions induced by the NGPA of 1978. This distress will result in long-run under-investment in the gas pipeline industry and thus higher long-run costs to consumers for natural gas.

The study sponsored by Citizens Energy Corp., referenced by the FERC, which purports to measure the consumer benefit of the block billing proposal, assumes that the procedure will induce a reduction in Block 2 prices, but blindly ignores the mechanism by which those prices would fall and the resulting transition costs.

(In the comments below, single page numbers in parentheses refer to the text of the FERC block billing Notice.)

I. THE EFFECTS OF BLOCK BILLING ON GAS PIPELINE AND CONSUMERS

The FERC block billing proposal is an "entitlements" program. [1/] It is designed to make the quantities of higher-priced Block 2 gas offered by pipelines the "marginal" supplies to their customers (p. 21). Customers are thus encouraged to "swing" to cheaper Block 2 suppliers or to locate their own marginal supplies for transportation through Order 436 transportation (assuming they have access to a pipeline which has taken an Order 436 transportation certificate) to the extent that those marginal supplies are offered at prices below the price offered for Block 2 gas. Given the level and distribution of Block 2 prices (reproduced in Table 1 for 25 major pipelines), this will almost certainly be the case.

Even if customers are unable to substitute cheaper gas for Block 2 supplies, demand elasticity will guarantee that they will cut back on their purchases of the marginal Block 2 supply at its current average price of approximately $3.60/Mcf. 2/ Indeed, in the context of Order 436, the FERC has given firm customers a unilateral right to reduce their contract demands by 25% per year. To the extent this right is exercised, it will be done at the expense of Block 2 supplies. Thus, there is ample reason to believe that the block billing proposal will put substantial downward pressure on Block 2 prices.

A. Will Block 2 Prices Fall?

The fact that "pressure" will be placed on Block 2 supplies does not necessarily mean that these prices will fall of their own accord. The key question is not, as the FERC seems to believe, the level to which Block 2 prices will fall (p.8, question 1). The key question is instead the mechanism by which these prices will fall under block billing -- a question which the studies of consumer benefits, referred to by the FERC, seem quite willing to ignore. Block 2 gas is "unmarketable" not just because its current price is above the "market-clearing" level. More significantly, it is "unmarketable" because pipelines would be unable to sell this gas at the prices which they are currently obligated to pay producers under contract, even if they sold it to their customers at market-clearing price levels.

Table 1

DISTRIBUTION OF BLOCK 1 AND BLOCK 2 GAS SUPPLIES

	Block 1 Cost	Block 1 Volume	Block 1 % of Total	Block 2 Cost	Weighted Average Cost
ANR	1.62	320.30	48.50%	4.04	2.87
Arkla, Inc.	1.36	61.30	27.00%	2.90	2.48
CIG	0.84	133.40	48.90%	3.99	2.45
Columbia	1.65	206.80	32.70%	3.77	3.08
Consolidated	1.89	37.10	6.50%	3.58	3.47
El Paso	1.29	370.90	38.40%	3.54	2.68
Florida Gas	1.50	84.70	37.50%	3.80	2.94
KN Energy	0.84	55.40	61.00%	3.96	2.06
MRT	2.00	11.90	7.20%	3.38	3.28
National Fuel Gas	1.20	6.60	3.70%	3.82	3.72
NGPL	1.52	436.60	42.90%	3.40	2.59
Northern Natural	1.04	326.10	47.80%	3.94	2.55
Northwest Central	0.85	147.30	58.40%	3.79	2.07
Northwest	1.25	70.00	23.20%	3.42	2.92
Panhandle Eastern	1.06	125.90	33.60%	3.83	2.90
Sea Robin	1.72	82.30	64.70%	3.96	2.51
Southern	1.47	181.00	36.90%	3.49	2.74
Tennessee	1.87	454.70	51.00%	3.87	2.85
Texas Eastern	0.78	237.60	25.30%	3.38	2.72
Texas Gas	1.78	165.20	33.70%	3.77	3.10
Transco	1.92	269.60	33.70%	3.60	3.03
Transwestern	1.38	41.30	15.60%	3.14	2.87
Trunkline	2.01	189.70	64.60%	4.36	2.84
United	1.70	136.60	24.20%	3.20	2.84
Williston (Mont-Dak)	1.50	8.60	20.70%	3.15	2.81
All	1.46	4161.90	36.10%	3.60	2.83

Source: Foster Associates PGA Subscription Service, as reported in comments of the Natural Gas Supply Association to FERC in Docket RM85-1, July 15, 1985.

Thus, in order for Block 2 prices to fall, the FERC must assume that one of three circumstances will occur under block billing.

- Pipelines and producers will renegotiate the price terms of their Block 2 contracts.
- Pipelines will "buy out" the past and future take-or-pay liabilities in their Block 2 contracts, flowing through all or some of this amount to ratepayers.
- Pipelines will "absorb" the difference in price between Block 2 and "market-clearing" supplies.

Although it is not explicitly stated, the FERC seems to have some or all of these circumstances in mind. From an economist's point of view, all of these possibilities collapse to essentially the same economic result. That is, whether payments are made in the form of "buy-outs" or are financially "absorbed", it is unlikely that something can be obtained for nothing in the realm of contract renegotiation. Despite the FERC claim that pipelines have an inadequate incentive to renegotiate their Block 2 contracts (Exhibit S, p. 51), the fact is that renegotiation will only occur at a price. A rational producer will only renegotiate a contract if offered the present value of the future claims on the pipeline's cash flow that the contract represents (or that a litigation outcome is likely to provide him). 3/ This value is conceptually the same as the amount a pipeline would have to offer a producer to "buy-out" all future take-or-pay liabilities under the contract.

It also is related to the present value of the amount which pipelines would have to "absorb" annually in order to sell their Block 2 supplies at the market-clearing price.

It is important to recognize that in the context of their Block 2 gas contracts with pipelines, producers hold a financial claim on the assets (the future cash flow) of the pipelines that is exactly analogous to the prior claim held by pipeline bondholders, [4/] even though these claims do not appear as dollar values on the pipeline accounting and regulatory balance sheets. [5/]

B. The Scale of Pipeline Financial Exposure under Block Billing

Whether the pressure of block billing on Block 2 prices is relieved through contract "buy-outs" or pipeline "absorption", it is clear that the FERC has not fully comprehended the dollar magnitude of the burden created that would have to be borne largely by pipeline investors under the proposed system.

Table 2 represents a series of simple calculations of financial exposure for the same 25 pipelines reported in Table 1, based on the conservative assumptions that the wellhead market clearing price for Block 2 supplies is $2.75 per Mcf and that pipelines would be obligated to take 60 percent of their current Block 2 volumes or pay producers anyway under their contracts. This latter assumption is extremely conservative in that the Block 2 volumes reported in the Foster Associates data in Column 1 already represent volumes taken which are substantially below contract maximums.

Column 2 of Table 2 reports the annual cost of all Block 2 volumes above the assumed market clearing price, while Column 3 reports the amounts

Table 2

ANNUAL FINANCIAL IMPACTS OF PIPELINE BLOCK 2 "ABSORPTION"

Market price = $2.75/Mcf
Min. Take = 60%

	Block 2 Volume	Block 2 Cost > Market (millions)	Block 2 Exposure (millions)	1983 Net Income (millions)	Exposure as % of Net Income
ANR	340.11	$ 438.74	$ 263.25	$ 178.46	147.51%
Arkla, Inc.	165.74	24.86	14.92	59.12	25.23%
CIG	139.40	172.86	103.71	67.76	153.06%
Columbia	425.62	434.13	260.48	92.02	283.07%
Consolidated	533.67	442.95	265.77	90.52	293.60%
El Paso	594.99	470.04	282.02	55.39	509.16%
Florida Gas	141.17	148.23	88.94	30.75	289.22%
KN Energy	36.06	43.63	26.18	31.45	83.24%
MRT	153.38	96.63	57.98	22.60	256.53%
National Fuel Gas	171.78	183.80	110.28	15.95	691.42%
NGPL	581.12	377.73	226.64	133.84	169.33%
Northern Natural	356.12	423.78	254.27	232.65	109.29%
Northwest Central	104.93	109.12	65.47	42.54	153.91%
Northwest	231.72	155.26	93.15	48.53	191.95%
Panhandle Eastern	248.80	268.71	161.22	133.73	120.56%
Sea Robin	44.90	54.33	32.60	18.57	175.55%
Southern	309.51	229.04	137.42	106.24	129.35%
Tennessee	436.87	489.29	293.58	715.76	41.02%
Texas Eastern	701.53	441.96	265.18	232.11	114.25%
Texas Gas	325.01	331.51	198.90	100.87	197.19%
Transco	530.40	450.84	270.50	146.21	185.01%
Transwestern	223.44	87.14	52.29	30.34	172.33%
Trunkline	103.95	167.36	100.42	33.76	297.45%
United	427.86	192.54	115.52	68.28	169.19%
Williston (Mont-Dak)	32.95	13.18	7.91	36.00	21.96%
All	7366.91	6247.66	3748.60	2723.45	137.64%

Source: Foster Associates (Col. 1); U. S. DOE, Financial Statistics of the Interstate Pipeline Companies (Col. 4); and author's calculations.

above the market price which pipelines would be obligated to pay for, under the 60 percent assumption. In other words, this amount in Column 3 represents the additional dollar amount which pipelines would be obligated to pay producers if they were able to sell all of the Block 2 volumes at the market price. As noted, this total annual exposure is greater than $3.75 billion for this sample of 25 pipelines.

Columns 4 and 5 of Table 2 compare this annual exposure with the 1983 net income after tax of the sample pipelines. The annual exposure is greater than 135 percent of annual net income for these pipelines. This implies that pipeline "absorption" of the financial impact of block billing on Block 2 supplies is a financial impossibility. This absorption would require all the pipelines annual retained earnings, all of the dividends paid to shareholders, and in fact would require substantial borrowing -- not for new investment purposes, but just to meet the financial claims on their assets. Such absorption is a recipe for Chapter 11 status.

Similarly, if pipelines were to "buy-out" these contracts, it could be expected that rational producers would demand a payment corresponding to approximately the present value, over the average Block 2 contract lifetime, of this magnitude of annual exposure. If the average lifetime were 10 years for the Block 2 contracts held by the pipelines in Tables 1 and 2, the total required buy-out to compensate for the present value of these contract claims would be on the order of $25 billion. 6/

It it unclear whether the FERC is prepared to see "buy-out" amounts of this magnitude in the context of Section 4 rate hearings. More importantly, it is likely that even if these magnitudes were amortized and passed-through in pipeline rates, these rates could not be sustained due to competition from alternative fuels.

The lesson here is that there is no free lunch with respect to Block 2 prices. A program which is based on putting downward pressure on Block 2 prices must eventually cope with the question of who will bear the financial liability associated with the Block 2 contracts. The FERC's analysis seems to completely ignore the implications of these contracts, even though they are the central economic factor behind the current gas surplus and the sluggishness of the industry in eliminating the surplus. [7/]

C. The FERC Exhibit S Economic Model

In its defense of the block billing proposal, The FERC has prepared an economic "model" of natural gas supply and demand (Exhibit S of Final Rule). Four principal conclusions are drawn by the FERC from their analysis (p.2). A few brief comments on each of these follows below:

1. Block billing will not create a shortage.

The FERC analysis in Exhibit S has concluded that block billing will cause equilibrium to be achieved in the gas industry (p. S40). The Exhibit S model is a static, partial equilibrium model. Unfortunately, the equilibirum nature of the model divorces it from reality. Now we all would agree that equilibrium models have their place and frequently demonstrate their usefulness, particularly in studying commodity markets. But unfortunately, the gas market is substantially out of equilibrium -- we have a surplus and we have cycled from shortage to surplus over the last decade. It is widely understood that regulation (plus contractual rigidities which have their origin in regulatory policy) is responsible for this disequilibrium condition, and that changes in regulation might rectify this condition. But to assert that block billing plus Order 436 are the policies which will produce equilibrium, based on a model that assumes equilibrium as an initial condition, is to assume away the problem.

In order to analyze whether block billing will move the gas market toward equilibrium it is necessary to model (or at least understand) the initial disequilibrium conditions in the industry and the costs associated with moving away from that position. The FERC model in Exhibit S would say that a gas surplus could not exist as long as some gas supplies have been decontrolled. This result flies in the face of current observed reality.

In addition, a few words about the concept of a gas "shortage" are in order. Technically, a shortage results when there is an excess of demand over the supply available at prevailing prices. Shortages of this type can occur for protracted periods due to sudden dislocations or demand spikes. Both types of shortages impose costs on individuals and society. But as long as most supplies are not subject to price controls and are allowed to move, protracted shortages will not likely occur. This is independent of whether block billing is or is not implemented.

The question of whether block billing will or will not impose costs through protracted shortages is not the right question to ask. The more appropriate question is whether block billing affects gas supply incentives in a way which imposes costs on individuals and society (just as a true shortage imposes costs).

2, 3. Monopoly rents should be distinguished from scarcity rents. Block billing plus Order 436 will eliminate monopoly rents.

The entire discussion of monopoly rents in the context of this problem in Exhibit S is quite puzzling. The author fails to connect the issue of monopoly to any of the structural, cost or regulatory conditions of the gas industry. The argument put forward suggests somehow that gas pipelines possess monopoly power and that somehow producers benefit as a result (pp. S 49-51). Under what conditions would a regulated gas pipeline wish to restrict output in order to raise price (as would a textbook monopolist)? The only way that gas pipelines earn "excess" profits is by moving volumes in excess of the test year volumes used to compute their transportation rates. The incentives exist in the system for pipelines to desire lower not higher cost gas moving through their systems for in this way they move greater volumes of gas. Isolated examples of pipeline monopsony power might be imagined, but not monopoly power under the current regulatory scheme.

This misconception leads one to wonder about the stated benefits of block billing and Order 436 in increasing "the pressure on interstate pipelines to negotiate lower prices with the owners of old gas" (p. S 51). Pipelines already have this incentive to minimize purchased gas costs. If this is the purpose of the entire policy change, it is unnecessary.

4. The distribution of scarcity rents depends on retail rate policy.

This conclusion regarding the distribution of economic rents has implications for the efficiency of the block billing policy as well as its equity (rent distribution). If the distribution of rents through rolled-in pricing induced the inefficiencies that the Commission is seeking to correct, then the transfer of those rents to the retail end of the system through block billing will also induce a set of inefficiencies. What the Commission failed to analyze in Exhibit S (or anywhere else in the rulemaking) is whether the inefficiencies block billing will induce will be greater or less than those induced by the current distribution of rents. Thus, just as rent distribution will depend on retail rate policy, so too will the costs of block billing depend on retail rate policy.

D. Short Run Benefits of Block Billing to Gas Consumers

In its Supplemental Notice, the FERC makes reference to "studies" which purport to measure the consumer benefit of the block billing proposal. It, however, cited only one by R. Leone, Block Billing of Natural Gas, commissioned by Citizens Energy Corporation in September of 1985 (p.4).

This study attempts to measure on a state-by-state basis the benefits to consumers of lower Block 2 gas prices. The calculation is very straightforward. Block 2 prices are assumed to fall to the pipelines' weighted average cost of gas (WACOG). The difference between the consumers' Block 1 prices and their supplying pipelines' WACOG's, multiplied by the customer volume entitlement of Block 1 gas, constitutes the savings and thus benefits to consumers of the block billing proposal. The total savings over all states based on this study is reported by the FERC to be "greater than $3.3 billion" (p.4).

Of course, as mentioned above, this study ignores the process by which Block 2 prices would fall. It is not surprising that the total calculated benefits to consumers is on the same order of magnitude as the annual pipeline Block 2 financial exposure due to the proposal which was calculated above. The FERC Notice presumes that the issue of Block 2 prices is merely one of a redistribution of rents between classes of producers (see the FERC Exhibit S "model"). This would be true if the renegotiation of producer/pipeline contract prices were a purely frictionless exercise. Unfortunately, this is not the case as the persistence of the current gas surplus demonstrates.

The Leone study's consumer benefits are thus purely short-run benefits. Given the high probability that block billing will cause serious financial distress in the pipeline sector of the industry, the long run implications of block billing will involve under-investment in pipeline service and physical capital which inevitably will lead to higher long run costs to consumers.

II. THE FERC's ECONOMIC JUSTIFICATION FOR BLOCK BILLING

To this point my comments have primarily considered the negative effects of the block billing proposal on the gas pipeline industry and long-run gas consumer interests. Is there a compensating positive economic justification for the block billing proposal which outweighs these concerns?

The FERC's justification for the block billing proposal is radical. Their argument is that block billing is necessary because "full rolled-in pricing ... is an unjust an unreasonable rate, charge, or practice under Section 5 of the NGA" (p. 16).

Four economic conditions are cited as being required for a just and reasonable rate for natural gas (pp. 16-17). To be "just and reasonable" FERC says a rate must:

- Promote efficiency in production and consumption;
- Permit "fair" competition;
- Not lead to wasteful depletion of scarce resources;
- Not distort the benefits of access to transportation.

Only the first of these has any unique economic content. The last three conditions are merely partial restatements of the efficiency criterion.

The FERC asserts that "full" rolled-in pricing is inefficient for all four reasons (I will address this below). Even if we were to assume they were right about this, it is then admitted that block-billing does not eliminate rolled-in pricing. Instead, "partial" rolled-in pricing is being substituted for "full" rolled-in pricing (pp. 26-27). If "full" rolled-in pricing is unjust and unreasonable under the criteria above, one has to wonder how "partial" rolled-in pricing meets the same criteria. The only conceptual economic distinction between "full" and "partial" rolled-in pricing, as the FERC has defined it, is that "partial" rolled-in pricing helps level the transportation playing field (or so it is claimed). But that is only one of the four criteria for "just and reasonable" rates. FERC's entire conceptual economic justification for block-billing, as articulated in the Supplemental Notice, is self-contradictory.

A. Is Rolled-in Pricing Inherently "Unjust and Unreasonable"?

Technically, rolled-in pricing is just one form of average-cost pricing. There is nothing inherently inefficient about average cost pricing as long as input prices are free to move. In fact, in cases where a firm's costs fall with expanding output (say, due to economies of scale) it is inefficient not to price on an average cost basis. This is the principle behind pipeline transportation rates, for example, where the various non-gas costs of doing business (labor, materials, etc.) are "rolled-in" to determine average rates. Because of the scale economies in pipeline transportation, marginal costs are less than average costs and competitive marginal cost pricing would put the firm out of business. Extending this example, if there were government wage floors on the pipeline's employees which propped up salaries, then these higher wages would be rolled into the pipeline's transportation rates and inefficiencies would result (i.e., the firm would use too little labor relative to capital and the consumer would use too little of the pipeline transportation service). But note that the inefficiency results directly from the wage controls and not from average cost pricing. In exactly the same way, the inefficiency which FERC seeks to eliminate with block billing results directly from the controls on old gas prices and not from the practice of rolled-in pricing.

The Commission goes to great pains to dispute the notion that price controls on old gas and not "rolled-in" pricing are the source of the gas market distortions of recent years (pp. 37-39). But the FERC's response (p. 38) is circular. Essentially they argue that without rolled-in pricing, the old-gas cushion would not cause economic distortions, therefore the source of the problem is rolled-in pricing. Recall my example above, rolled-in pricing is nothing more and nothing less than average-cost pricing, and is not inherently distorting if input prices are free to move.

B. Does Block Billing Level the Playing Field?

One of the key features of block billing from the FERC's point of view is that it prevents pipelines from employing their endowments of old gas to their competitive advantage by selectively moving this gas through their Order 436 transportation programs. But "old" gas is not the only gas which may give a particular pipeline a competitive advantage or disadvantage. That is, unequal endowments of Block 2 gas supplies and contract terms (such as market-outs and take-or-pay exposure) may create pipeline competitive problems. Table 1 above demonstrates that interpipeline disparities in Block 2 prices are as large or larger than disparities in Block 1 endowments.

More significantly, it is widely admitted that all the block billing proposal does is transfer the old gas cushion to the local distribution company level of jurisdiction. Since in the new Rule's environment LDC's will be competing against pipelines in the field for gas supplies, block billing will tilt the playing field in favor of the LDC's in bidding for gas supplies, just as the NGPA gave interstates a bidding advantage over intrastate pipelines in the field during its initial years of implementation. This would lead to all the same inefficiencies of rolled-in pricing in production and consumption that FERC recites in their block billing justification.

FERC does state that for the benefits of block-billing to be achieved, state PUC's must mandate block-billing at the LDC level (p.23). But is this sufficient? Suppose that every state did require LDC's to block bill to each of its customers. Suppose an industrial user on an LDC network received block-billed gas. What is to prevent the industrial user from taking only its Block one entitlement from the LDC, and then procuring its remaining gas in the field with non-discriminatory pipeline transport? In this case the industrial user has the economic advantage over both the LDC and the pipeline in the field market and the playing field is not level. The lesson here is obvious. As long as some gas remains under price controls it is impossible to pass these these rents downstream in hopes of eliminating the potential competitive advantages that this gas could represent. Another way of saying this is that it is impossible to eliminate the claimed negative effects of rolled-in pricing as long as some gas remains under price controls. It should be obvious, then, that rolled-in pricing is not the fundamental problem. The problem is continued controls on the pricing of old gas.

On balance, if one reviews the stated economic rationale for the block billing proposal, the FERC definitions of a "just and reasonable" rate policy, and the negative effects of block billing on the regulated pipeline industry, one must reach the conclusion that block billing is, at a minimum, unjustified and internally inconsistent and, at a maximum, is harmful to the long-term interests of natural gas consumers in obtaining assured gas supplies at least cost.

FOOTNOTES

1/ There seems to be some confusion about whether block billing is a simple "billing mechanism" or an "entitlements program". For the program to have the price effects that the FERC claims for it, it has to be an entitlements program. It would thus grant pipeline customers the right to take all of their Block 1 allocation and cut back on or substitute for Block 2 gas. If it did less than this, i.e., if it required (somehow) customers to always take pro rata shares of Block 1 and Block 2, then the program would be functionally no different than full rolled-in pricing and would have no economic effects. FERC's economic "model" (Exhibit S) assumes that block billing is an entitlements program (see Exh. S p. 32).

2/ Dual-fired boiler users will have a particular incentive to use up their Block 1 entitlement and then switch to residual oil for their remaining requirements.

3/ Another billing option which would have allowed the pipeline to offer the renegotiating producer preferential treatment by divorcing the renegotiated supply into a separate "block" for pricing purposes was rejected by the FERC on the grounds that it might interfere with state prorationing laws and might constitute a "force majeure" defense to breach of contract (pp. 62-63).

4/ It is clear that both claims would be superior to those of the pipeline stockholders.

5/ For a more complete conceptual and empirical discussion of pipeline gas supply contracts as financial liabilities, see P. R. Carpenter, Natural Gas Pipelines After Field Price Decontrol: A Study of Risk, Return and Regulation, PhD Dissertation, Massachusetts Institute of Technology, March 1984, MIT Center for Energy Policy Research Technical Report No. 84-004.

6/ If producers expected a litigated outcome to prevail in the pipelines favor, the required buy-out would no doubt be less.

7/ See, for example, the statement on p. 65: "... nothing in the rule would prohibit a pipeline from excluding from its Block 2 rate the costs of any gas which the pipeline determines to be unmarketable and therefore does not take from the producer." Of course, even though the pipeline does not take the gas from the producer, he is likely to have to pay for it at the contract price. This is evidence of the FERC belief that pipelines can "absorb" the financial effects of block billing.

BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol	)))	Docket No. RM85-1-000 (Part D)

VERIFICATION

STATE OF CALIFORNIA)
) ss.
COUNTY OF LOS ANGELES)

Paul R. Carpenter, being first sworn according to law, on oath deposes and says that he is the individual whose statement in the above-captioned proceeding accompanies this verification; such statement represents his considered views and is authorized to be filed before the Federal Energy Regulatory Commission in the subject docket.

Paul R. Carpenter

SUBSCRIBED TO AND SWORN
to me this 13th day of
November, 1985.

OFFICIAL SEAL
MARSHA OSEAS
My Comm. Expires Jan 2 1989

Notary Public, State of California
County of Los Angeles

My Commission Expires: 1-2-89

PAUL R. CARPENTER

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Education

Ph.D., Massachusetts Institute of Technology, Cambridge, MA: Applied Economics, 1984.

M.S., Massachusetts Institute of Technology, Cambridge, MA: Management, 1978.

B.A., Stanford University, Palo Alto, CA: Economics, 1976, (with Honors).

Employment

Incentives Research, Inc., Newton, MA and Los Angeles, CA

(1983 - Present): Vice President of firm providing economic and financial counsel in the fields of oil and gas regulatory policy, economics, antitrust, and technology policy.

MIT Center for Energy Policy Research, Cambridge, MA

(1981 - Sept. 1984): Research Staff and post-doctoral fellow.

Putnam, Hayes & Bartlett, Inc., Cambridge, MA:

(1980): Associate

NASA/Caltech Jet Propulsion Laboratory, Pasadena, CA.

(1978 - 1980): Economist and Project Manager.

MIT Energy Laboratory, Cambridge, MA.

(1976 - 1978): Research staff.

Fields of Specialization

Industrial Organization
Regulation
Energy Economics
Corporate Finance and Strategy
Technology Development

Academic Honors and Fellowships

Stewart Fellowship, 1983
MIT Felloships, 1981, 1982, 1983
Brooks Master's Thesis Prize (Runner-up), MIT, 1978

Publications

"Life on the Demand Curve: Adapting to Change in Natural Gas Markets", in Energy, Markets and Regulation: What Have We Learned?, with Henry D. Jacoby and Arthur W. Wright, MIT Press, Cambridge, MA. (forthcoming).

"An Economic Comparison of Alternative Methods of Regulating Oil Pipelines, Incentives Research, Inc., with Gerald A. Taylor, Report to the U. S. Department of Energy, Office of Competition, (forthcoming July 1985).

"The Natural Gas Policy Drama: A Tragedy in Three Acts", with Arthur W. Wright, MIT Center for Energy Policy Research Working Paper £84-012WP, October 1984.

Oil Pipeline Rates and Profitability under Williams Opinion 154, Incentives Research, Inc., with Gerald A. Taylor, Report to the U. S. Department of Energy, Office of COmpetition, September 1984.

Natural gas Pipelines After Field Price Decontrol: A Study of Risk, Return and Regulation, Ph.D. Dissertation, Massachusetts Institute of Technology, March, 1984, published as Report to the U. S. Department of Energy, Office of Oil and Gas Policy, MIT Center for Energy Policy Research Technical Report £84-004.

"Field Price Decontrol of Natural Gas, Pipeline Risk and Regulatory Policy", in Government and Energy Policy, ed. Richard L. Itteilag, Washington, D. C., June 1983.

"Risk Allocation and Institutional Arrangements in Natural Gas", with Arthur W. Wright, invited paper presented at the American Economic Association Meetings, San Francisco, CA, December 1983.

"Vertical Market Arrangements, Risk-shifting and Natural Gas Pipeline Regulation", Sloan School of Management Working Paper £1369-82, September 1982 (Revised April 1983).

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"Perspectives on the Government Role in New Technology Development and Diffusion", with Drew Bottaro, MIT Energy Lab Report £81-041, November 1981.

International Plan for Photovoltaic Power Systems, Solar Energy Research Institute with the Jet Propulsion Laboratory (co-author). Prepared for the U. S. Department of Energy, August 1979.

Federal Policies for the Widespread Use of Photovoltaic Power Systems, Jet Propulsion Laboratory (contributor). Report to the U. S. Congress DOE/CS-0114, March 24, 1980.

"An Economic Analysis of Residential, Grid-connected Solar Photovoltaic Power Systems", MIT Energy Laboratory Technical Report £78-007, with Gerald A. Taylor, May 1978.

Other Unpublished Speeches and Presentations

"Oil Pipeline Rates after the *Williams* 154 Decision", Executive Enterprices, Inc. Conference on Oil Pipeline Ratemaking, Houston, TX, June 19-20, 1984.

"Issues in the Regulation of Natural Gas Pipelines", California Public Utilities Commission Hearings on Natural Gas, San Francisco, CA. May 21, 1984.

"Financial Aspects of Gas Pipeline Regulation", Pittsburgh Conference on Modeling and Simulation, Pittsburgh, PA, April 19-20, 1984.

"Natural Gas Pipelines After Field Price Decontrol", Presentations before Conferences of the International Association of Energy Economists, Washington D. C., June 1983, and Denver CO, November 1982.

"Spot Markets for Natural Gas", MIT Center for Energy Policy Research Semi-annual Associates Conference, March 1983.

"Pricing Solar Energy Using a System of Planning and Assessment Models", Presentation to the XXIV International Conference, The Institute of Management Science, Honolulu, HI, June 20, 1979.

Professional Affiliations

International Association of Energy Economists

Consulting Activities

1985	For the U. S. Department of Energy, an analysis of the economic effects of various proposed methods of oil pipeline regulation.
1985	For the NASA Jet Propulsion Laboratory, an evaluation of the commercial potential of earth remote sensing activities on board the NASA Space Station.
1984-85	For a major natural gas pipeline company, provision of expert testimony on the economics and regulation of the U. S. natural gas industry in on-going antitrust litigation.
1984	For the U. S. Department of Energy, a study of the effect on oil pipeline rates and profitability of changes in oil pipeline regulation proposed by the Federal Energy Regulatory Commission in the Williams 154 Opinion.
1984	Assistance in preparation of expert testimony in dispute before the International Trade Commission on the competitive effect of foreign product into the U. S. market.
1984	Assistance in preparation of expert testimony before a state pulic utility commission regarding the pricing of local telecommunications service after the AT&T divestiture.
1980-81	For a major U. S. coal producer, an assessment of the effects of safety and environmental regulations on coal production costs and the calculation of damages associated with non-performance under long-term coal supply contracts.
1980-81	For several large utility companies, analysis of the financial feasibility of continuing investments in coal and nuclear generating plants under construction.

Senator **Nickles**. Mr. Kalen, thank you very much. We appreciate your comments.

Our next panelist we have is Robert Harbor, vice president for El Paso Natural Gas.

STATEMENT OF ROBERT N. HARBOR, VICE PRESIDENT, EL PASO NATURAL GAS CO.

Mr. **Harbor**. Thank you, Mr. Chairman.

I appreciate this opportunity to appear before you today to tell you of our actions, as well as our reactions to the transportation program established by the Federal Energy Regulatory Commission's order 436.

To begin with, I would like to give you a little background. The El Paso pipeline system has the capacity to transport and deliver almost 4 billion cubic feet a day of natural gas from major gas supply sources in western Oklahoma, Texas, and New Mexico to major gas markets in Texas, New Mexico, Arizona, Nevada, and California.

Traditionally, like other interstate pipelines, we have principally performed what today is being called the merchant role, buying natural gas in the field, treating it to pipeline quality, transporting it to the marketplace and selling it to direct end users and local distribution companies.

Since 1938 this activity has been pervasively regulated by the Federal Power Commission and then its successor, the Federal Energy Regulatory Commission. Inherent in this merchant role activity has been our public service obligation to acquire and maintain sufficient gas supplies to serve the present and future requirements of our customers at reasonable prices.

Although traditionally subordinate to our merchant role, for a number of years we have also been transporting gas for others. Recently this activity has taken on added importance to the El Paso systems.

In July of this year El Paso's largest sales customer, Southern California Gas Co. which, incidentally, is the largest natural gas distributor in the Nation, began to aggressively seek low-cost gas supplies through direct purchases from producers in the spot market.

Even though these spot supplies were in competition with our own gas supplies for the southern California market, we had the available capacity and, therefore, we agreed to transport the spot gas on an interruptible basis.

In August of this year, El Paso's second largest customer, Pacific Gas & Electric, also began to buy spot gas. Soon a number of other of El Paso's customers followed suit.

From July through October, El Paso has transported more than 70 billion cubic feet of spot gas for these customers. Each month since August, where the FERC rules permit, we have released committed gas supplies in Oklahoma from our producers, as well as in other supply areas, so that our producer suppliers might participate in this spot market activity on our system.

Through the release program, El Paso has transported to our customers' spot markets as much as 200 million cubic feet of gas per day for more than 500 participating producers.

Now, against this backdrop of activity, let us take a look at order No. 436. At the outset, let me say that even though the FERC has postponed for further consideration its most radical proposal, the elimination of rolled-in pricing and the imposition of block billing, the FERC's new transportation program and rate conditions immediately pose a number of serious questions and concerns to El Paso.

Of immediate concern was whether El Paso's ongoing transportation arrangements could continue after November 1 without automatically subjecting the company to open access status before the new rule could be fully understood. El Paso and many others immediately asked the FERC to clarify various aspects of the rule's grandfather provisions.

Pending clarification, El Paso halted all self-implementing transportation services on November 1. I think an understanding of this is important because it addresses in part a concern Mr. Baker had raised a little bit earlier while he was on the witness stand.

El Paso had asked the Commission to clarify where it would stand under the rule and on November 8 the final questions were answered by the FERC and El Paso was permitted to resume most of the ongoing transportation services on a grandfathering basis.

Today we are transporting about 660 million cubic feet of spot gas through our system, including approximately 110 million cubic feet of released gas for more than 200 of our major producer suppliers.

Mr. Chairman, as an aside on this matter, in the time interval between November 1 and November 8, as I mentioned, El Paso was not transporting gas because we did not exactly know where we would stand.

We exerted every effort at our disposal to get clarifications out of the Commission. To give you some measure of how serious we were taking this matter, I had understood that a Commission order had issued after the Commission had closed on November 8 and I left my fireside to go down to the Commission, and you know where that area is, at 10:30 at night, and knock on the door and get the guard to let me in.

I hand-copied the order and telephoned that to our people in El Paso so that they could immediately begin operations with our customers to get that gas moving again. And we did, indeed, do that.

Now, on November 8 we filed with FERC El Paso's request for rehearing and clarification of the order 436 and on November 18, then, we filed supplemental comments concerning the block billing proposal.

I will not burden you with the long version of El Paso's comments. However, I would like to briefly identify the major problems that we find with order 436.

First, pipeline capacity is not going to be freed up for open access transportation because order 436 regulations permit existing pipeline customers to retain and control all existing firm pipeline capacity.

Second, accurate price signals will not move between the wellhead and the burner tip unless the FERC assures that local distribution companies and Hinshaw pipelines give their end users an open access to natural gas supplies at the wellhead.

Third, if the FERC does not provide interstate pipelines and their producer suppliers some incentive to renegotiate their contracts, the rights of an open access pipeline's customers to reduce their pipeline purchase obligation will further aggravate the current take-or-pay situation.

El Paso believes that FERC's goals can be accomplished if it will modify its final rule to establish a balanced transportation program that:

One, assures that end users have equal access at the wellhead to natural gas supplies.

Two, assures present customers that they will not bear additional costs for the same services they are now receiving.

Three, does not unreasonably increase the pipeline's risk of cost under recovery.

Four, assures that adequate and reliable supplies will be available to serve present and future supply needs.

We believe that FERC can and should revise its order to establish a balanced and equitable transportation program fair to all segments of the natural gas industry. If it will not, we believe that legislation will be required and we are prepared to work with the producers, pipelines, distributors, and consumer groups toward this solution.

I will not take your time today to state our concerns with FERC's block billing proposal. After all, the invective that has already been heaped upon that proposal, I think it will suffice to say at this point that we oppose it.

If you have any specific questions, I would be happy to address them later. Our reasons are summarized in my statement to the committee.

Pending FERC clarification and reconsideration of its final rule, El Paso is continuing its discussions with our own customers to clarify and resolve certain service-related matters that we have and, hopefully, we can get those cleared up in the very near future.

In this connection, Mr. Chairman, I would like to advise you that on November 15, El Paso informed its customers and the California Public Utilities Commission that we expect to become an open access transporter pursuant to order 436 program not later than July 1, 1986, as soon as the CPUC proposed rules for open access transportation by local distribution companies and Hinshaw pipelines within California become final.

I might add that rule is now pending and we hope something can be resolved on it by early next year.

Further, that new service arrangements between El Paso and our California customers are concluded.

Mr. Chairman, El Paso is ready and willing to be a full participant in the new competitive environment under a balanced transportation program that treats all participants in a fair and equitable manner.

I would like to thank you for all of the work that you are doing to bring about some understanding and helping to reach a resolution of this most serious matter.

Thank you, Mr. Chairman. That concludes my statement.

[The prepared statement of Mr. Harbor follows:]

BEFORE THE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

Statement Of Mr. Robert N. Harbor
On Behalf Of
El Paso Natural Gas Company

Tulsa, Oklahoma
November 27, 1985

Mr. Chairman, Members of the Subcommittee, my name is Robert N. Harbor. I am a Vice President of El Paso Natural Gas Company.

I appreciate this opportunity to appear before you today to tell you of El Paso's actions and reactions to the Pipeline Transportation Program established by the Federal Energy Regulatory Commission's Order No. 436.

The El Paso pipeline system has the capacity to transport and deliver almost four billion cubic feet of gas daily from major gas supply sources in western Oklahoma, Texas, and New Mexico to major gas markets in Texas, New Mexico, Arizona, Nevada, and California.

Since 1938, virtually every aspect of El Paso's business activity has been pervasively regulated, first by the Federal Power Commission and, since 1977, by the Federal Energy Regulatory Commission.

For example:

> El Paso cannot construct, operate or abandon its pipeline facilities without FERC permission.
>
> Except to the extent permitted for certain transactions by the Natural Gas Policy Act of 1978, El Paso cannot initiate or terminate sales or transportation arrangements on its pipeline system without FERC permission.
>
> Federal law determines the price which El Paso can charge its customers for gas.
>
> Even with the decontrol of "deep gas" prices in 1979 and the decontrol of other wellhead prices at the beginning of this year, federal law still controls the maximum price which El Paso can pay for more than seventy-two percent (72%) of its wellhead supplies.

Historically, El Paso, like other interstate gas pipelines, has principally performed what is today being called the "merchant role" -- buying natural gas in the field, treating it to pipeline quality, transporting it to the marketplace, and selling it to local distribution companies and direct end users.

Inherent in this role has been the public service obligation to acquire and maintain sufficient gas supplies to serve the present and future requirements of its customers. Following the passage of the NGPA which permitted pipelines to pay higher prices for natural gas, El Paso, like most interstate pipelines engaged in establishing gas acquisition activities to restore its depleted supply inventories in order to satisfy its public service obligations.

For the last several years, more than eighty percent (80%) of El Paso's annual sales have been to two distributors serving California.

In addition to its traditional "merchant" role, for a number of years El Paso has also transported gas for others.

For example, El Paso delivers more than 220 million cubic feet of Canadian gas each day to Southern California under long-term transportation arrangements approved in 1980 by the FERC in connection with the pre-build of the Alaska Natural Gas Transportation System.

Of far more significance to El Paso's customers, and to its producer suppliers, has been the transportation of substantial volumes of "spot gas" by El Paso this year under the FERC rules in effect prior to Order No. 436:

Recent FERC orders have effectively "freed" El Paso's customers of any obligation to purchase minimum volumes of gas from El Paso. Unfortunately, these orders do not eliminate El Paso's obligation to maintain an adequate supply for these customers, when and if they wish to buy gas from El Paso. As a result, El Paso faces the potential of substantial prepayments for gas not requested by its customers.

Since mid-summer, El Paso's two largest customers -- Southern California Gas Company and Pacific Gas and Electric Company -- subsequently joined by other El Paso customers, have each purchased substantial volumes of short-term, low-cost "spot gas" through monthly competitive bidding procedures. They requested and El Paso agreed to transport this gas. Subsequently, El Paso offered the same transportation services to all of its customers.

During the July through October period, El Paso has transported more than 70 billion cubic feet of spot gas for these customers under "self-implementing" arrangements permitted by the FERC's rules under the NGPA.

These spot gas transactions have generally displaced purchases by these customers from El Paso on an Mcf for Mcf basis, worsening El Paso's potential take or pay situation. In order to avoid shutting in supplies, and where permitted by FERC rules to do so, El Paso has offered to temporarily release its producer-suppliers in Oklahoma and elsewhere from their contract obligations to sell their gas to El Paso in order to bid it through an El Paso marketing affiliate into the spot gas market on El Paso's system.

During the months of August, September, and October, El Paso has transported up to 200 million cubic feet of release gas per day for the spot market from more than five hundred participating producers.

It was because of the foregoing transportation activities on the El Paso system that El Paso's President, Mr. Richard Morris, told this subcommittee in September that, while the FERC's objectives of encouraging competition in gas acquisition and marketing were "commendable," its rulemaking proposal at Docket No. RM85-1 prescribed "radical surgery to a patient already on the road to recovery."

Nevertheless, the FERC issued its Order No. 436 on October 9th. While the FERC postponed for further consideration its most radical proposal -- the elimination of rolled-in pricing and the imposition of block billing -- it's transportation program and rate conditions immediately raised a number of questions and concerns:

Of immediate concern to El Paso was whether a number of ongoing El Paso transportation arrangements previously authorized by the FERC's rules on a "self-implementing basis" could continue after

November 1st without subjecting El Paso to "open access" status. On October 18th, El Paso advised its customers that it could not make an "open access" decision until the FERC has responded through its rehearing process to various questions and concerns of El Paso about the final rule and until certain service-related matters between El Paso and its principal customers are resolved.

Over the remainder of October, El Paso and others asked the FERC to clarify various aspects of its "grandfather" provisions. Pending the requested clarification, El Paso halted all "self-implementing" transportation services on November 1st.

On November 8th, the final questions were favorably answered and El Paso resumed the ongoing transportation services on a "grandfathered" basis. Today, El Paso is transporting approximately 660 million cubic feet of gas for others through its system, including approximately 110 million cubic feet of release gas from more than two hundred of its producer-suppliers.

El Paso filed with the FERC its request for rehearing and clarification of Order No. 436 on November 8th, and on November 18th we filed our supplemental comments on the FERC's block billing proposal. I won't burden you with the "long version" of El Paso's comments. However, I would like to briefly discuss those areas of greatest concern which we feel impede the successful implementation of the Commission's proposal.

Regarding Order No. 436:

> First, the FERC's goal of "freeing up pipeline capacity" for non-discriminatory transportation is not properly carried out under the Order No. 436 Regulations because they permit existing firm sales

customers to retain their present firm sales contract entitlements and simultaneously secure unconditional access to interruptible transportation services. This potential preemption of all existing firm pipeline capacity, with no commensurate purchase obligation, unduly discriminates against captive end users and third party shippers.

Second, accurate wellhead to burnertip price signals cannot be sent unless the FERC assures that all end users have direct access, through both the pipeline and LDC and "Hinshaw" systems, to the purchase of supplies at the wellhead. To the extent that an LDC or "Hinshaw" pipeline refuses to play by the same rules applicable to interstate pipelines, many end users will be unable to acquire natural gas supplies at the wellhead.

Third, under Order No. 436, if an interstate pipeline elects to engage in "open access" transportation, its existing sales contracts with its customers may be materially revised at the option of those customers, to the further aggravation of its current take or pay situation. Yet, the FERC does not provide interstate pipelines with any corresponding relief from its wellhead purchase obligations.

El Paso believes that the FERC's goals can be accomplished if it will modify its final rule to establish a balanced transportation program that:

assures all end users equal access at the wellhead to natural gas supplies;

assures present customers that they will not bear additional costs for the same services;

does not unreasonably increase a pipeline's risk of cost underrecovery; and

assures that adequate and reliable supplies will be available to serve present and future supply needs.

These assurances can be provided if the FERC clarifies and modifies Order No. 436 as follows:

(i) Permit interstate pipelines to refuse interruptible transportation services to an existing customer unless the customer has first reduced or converted its firm sales entitlement by the amount of transportation it wished to receive;

(ii) Clarify that any reduction in a customer's firm sales entitlement also results in a corresponding reduction of the customer's entitlement in the pipeline's gas curtailment or allocation plan;

(iii) Eliminate those rate conditions applicable to transportation services under the final rule which deny pipelines the ability to recover their system costs and discriminate against transportation of pipeline's dedicated supplies;

(iv) Require that all blanket transportation programs on behalf of an LDC or a "Hinshaw" pipeline be conditioned to permit non-discriminatory access to all end users of that LDC or "Hinshaw" pipeline by both producers and interstate pipelines; and

(v) Permit an interstate pipeline to deny "open access" services to natural gas producers absent take-or-pay relief as to the transporting pipeline.

Regarding Block-Billing:

The block billing proposal will create dislocation and disruption of contractual relationships founded on more than fifty years of rolled-in pricing of gas supplies.

All existing El Paso gas sales contracts, and all El Paso marketing activities are, and have been, predicated on rolled-in pricing. the proposed block billing requirements so alter El Paso's markets that El Paso will be prevented from performing under many of its gas purchase contracts. El Paso's ability to perform under these contracts is directly linked to the continuation of rolled-in pricing.

Furthermore, the block billing concept will not achieve its objective unless consuming state PUC's follow the FERC's lead by requiring block billing at the distributor level to preserve the benefits of low-cost gas supplies for each identifiable customer class. If the consuming state PUC does not adopt block billing, then all that the FERC will have accomplished will have been to deliver the pipeline's price-controlled Block 1 gas into the hands of the LDC so that it might have an additional advantage in competing with the pipeline for gas supplies at the wellhead.

Compliance with the State conservation laws and regulations, coupled with market demand and operational constraints, will limit the volume of Block 1 gas which a pipeline can actually purchase at the wellhead and deliver to its customers. A pipeline will not be able to purchase Block 1 gas without also purchasing significant volumes of unmarketable Block 2 gas.

This situation will force pipelines such as El Paso to further reduce its current "market-out" prices in an effort to make Block 2 marketable, reducing producer revenues and hindering further gas exploration and development.

Although El Paso opposes block billing, if it is going to be adopted, Block 2 should be subdivided into a "market-responsive" sub-block and a "non-market-responsive" sub-block, giving producers with high-priced Block 2 gas contracts the incentive, and pipelines a tool, to renegotiate those contracts in order to move the gas into the marketable sub-block.

Pending FERC clarification and reconsideration of its final rule, El Paso is continuing its discussions with various customers to clarify and resolve certain service-related matters between them. In this connection, on November 15, 1985, El Paso's President informed our customers and the California Public Utilities Commission that El Paso expects to become an "open access" transporter pursuant to the Order No. 436 program, not later than July 1, 1986, as soon as the CPUC proposed rule for open access transportation by local distribution companies and "Hinshaw" pipelines within California becomes final and new service arrangements with its California customers are concluded. (A copy of that letter is attached to this statement.)

In conclusion, El Paso declares itself ready and willing to be a full participant in the new competitive environment under a balanced transportation program that treats all participants in a fair and equitable manner.

Thank you Mr. Chairman. That concludes my statement.

El Paso
Natural Gas Company

RICHARD S. MORRIS PRESIDENT

P O BOX 1492
EL PASO TEXAS 79978
PHONE 915-541-2079

November 15, 1985

To the Customers Served by the Interstate
Natural Gas System of El Paso Natural
Gas Company:

Enclosed, as a matter of information to you, is a copy of my letter of this date addressed to Mr. Donald Vial, President of the California Public Utilities Commission. As the enclosure states, El Paso expects, by midyear 1986, to become a transporter pursuant to the nondiscriminatory access provisions of Order No. 436 issued by the Federal Energy Regulatory Commission on October 9, 1985.

Very truly yours,

Richard S. Morris

RSM:hsw

El Paso
Natural Gas Company

RICHARD S. MORRIS PRESIDENT

P O BOX 1492
EL PASO TEXAS 79978
PHONE 915-541-2079

November 15, 1985

Mr. Donald Vial
President
California Public Utilities Commission
350 McAllister Street
San Francisco, California 94102

Dear President Vial:

Earlier this week you and your staff afforded us the opportunity to discuss El Paso Natural Gas Company's intentions concerning present and future operation of our interstate pipeline pursuant to Order No. 436 issued by the Federal Energy Regulatory Commission on October 9, 1985 and also pursuant to the transportation rule proposed by your Interim Opinion on October 17, 1985 in I.84-04-079. In our discussion, we informed you that El Paso has commenced negotiations with Southern California Gas Company and Pacific Gas and Electric Company with the objective of agreeing upon new terms of service, including firm sales service and both firm and interruptible transportation service, consistent with the new F.E.R.C. rule and the C.P.U.C. proposal. We also informed you that, although El Paso already is transporting substantial volumes of spot market gas to California under the "grandfather" provisions of the new F.E.R.C. rule, El Paso expects to become a transporter pursuant to the nondiscriminatory access provisions of the new F.E.R.C. rule as soon as the C.P.U.C. proposal is final and we have concluded new service agreements with the California distribution companies, but in no event later than July 1, 1986.

For the many reasons we discussed, we believe strongly that it is in the mutual interest of El Paso, the California distribution companies and all consumers of natural gas in the State of California that new service agreements be negotiated and concluded promptly in order that sales and transportation entitlements on El Paso's system are well defined at the time El Paso elects to become a transporter under the new F.E.R.C. rule. In our view, serious problems with respect to lack of firm contract demand under existing service agreements can be avoided by this course of action.

El Paso expects to begin transporting substantial volumes of natural gas for use in the enhanced oil recovery markets in southern California soon after your transportation proposal becomes final. El Paso has applied to the F.E.R.C. for specific authority to furnish these transportation services, but it may well become necessary for El Paso to elect to be a transporter under the new F.E.R.C. rule in order to commence that service in a timely manner.

We appreciate your interest in these matters, and we look forward to further meetings with you and your staff to keep you apprised of developments.

Very truly yours,

Richard S. Morris

RSM:hsw

cc: Mr. John Sproul
Pacific Gas and Electric Company
77 Beale Street
San Francisco, California 94106

Mr. Jonel Hill
Southern California Gas Company
P. O. Box 3249, Terminal Annex
Los Angeles, California 90051

Senator NICKLES. Mr. Harbor, thank you very much. I appreciate your willingness to come to Oklahoma and, certainly, in light of the fact that El Paso does buy so much Oklahoma gas and the fact that you were off and now on, and that makes a lot of difference.

We do appreciate your presentation before the committee.

Our next panelist we have is Charles Hughes, vice president of Gas Supply for Oklahoma Natural Gas.

Mr. Hughes.

STATEMENT OF CHARLES F. HUGHES, JR., VICE PRESIDENT, OKLAHOMA NATURAL GAS CO. AND ONG TRANSMISSION CO., DIVISION OF ONEOK, INC.

Mr. HUGHES. Mr. Chairman, ladies and gentlemen, I am vice president of Oklahoma Natural Gas Co. and ONG Transmission Co., both of which are divisions of ONEOK, Inc.

I appreciate this opportunity to appear before you today on behalf of ONG to discuss current problems in the natural gas industry, particularly problems stemming from the new rules issued by the Federal Energy Regulatory Commission in order 436.

Briefly, it is our view that in the commendable pursuit of fostering healthy competition in the natural gas industry, the FERC has issued new rules that have had the opposite effect by disrupting the flow of spot market gas.

Before the FERC's new rules governing transportation became effective on November 1, 1985, a healthy spot market for gas had developed. Many pipelines, including ONG, were increasingly providing transportation services to assist gas consumers in arranging direct purchases for producers and other nonpipeline gas marketers.

These transportation services were provided under a handful of blanket authorities that permitted parties to buy, sell, and transport gas on a self-implementing basis without prior approval from the FERC.

ONG made extensive use of the transportation authority available under section 311 of the Natural Gas Policy Act which allows intrastate pipelines to provide transportation in interstate transactions without jurisdictional consequences under the Natural Gas Act.

In addition, interstate pipelines were providing transportation services under section 311 and a host of other programs.

In order 436, however, the FERC radically changed the rules governing self-implementing transportation programs. Although certain transactions have been grandfathered, transportation programs under which large volumes of gas had been moving earlier this year have been eliminated and replaced by new order 436 transportation rules.

Unfortunately, the transition from the earlier widely used transportation programs to the new order 436 regime has not been successful, largely because the interstate pipelines by and large view the new transportation provisions as too onerous to be acceptable in the new environment and its consequences too uncertain at this time.

With these concerns, pipelines are hesitant to make decisions now that may affect them for years to come. Although ONG has successfully sought to continue its transportation service and mitigate difficulties for its shippers arising from the transition of order 436, we have heard reports of producers being shut in at one end of the pipeline and plants complaining about the loss of spot market gas at the other end of the pipeline.

There are some positive steps that the FERC can take to remedy this situation. ONG has pointed out on rehearing to FERC:

One, that the nondiscriminatory access requirement is tantamount to common carriage per section 311 transportation rules, which we believe is beyond the Commission's authority.

Two, that the technical corrections order FERC issued on October 24, 1985, changing the date from which transactions would be grandfathered from November 1 back to October 9, 1985, constitutes retroactive rulemaking in violation of accepted administrative procedures.

As a general matter, the FERC has dealt self-implementing transportation of natural gas a serious blow by imposing conditions on transporters that go far beyond the changes required by the DC Circuit Court in the *Maryland People's Council* cases.

The broad sweep of undue discrimination or reference outlined in order 436 can operate to deprive pipelines of their ability to make reasonable business decisions and should therefore be modified.

To correct the situation and enable pipelines to deal with their take-or-pay obligations, the FERC should revise the rules to make it clear that undue discrimination or preference in order 436 does not foreclose a pipeline from bargaining for take-or-pay relief in exchange for granting a producer access to transportation.

In conclusion, we wholeheartedly endorse close congressional oversight on natural gas transportation issues through activities such as this hearing today, but at this point we believe that the FERC and not the Congress is in the best position to deal with the problem.

However, we believe that Congress can and should address the removal of artificial restraints on natural gas demand imposed by incremental pricing and the Fuel Use Act.

I appreciate this opportunity to come before you and welcome any questions you may have later.

[The prepared statement of Mr. Hughes follows:]

UNITED STATES SENATE

BEFORE THE SUBCOMMITTEE
ON ENERGY REGULATION AND CONSERVATION
OF THE COMMITTEE ON ENERGY
AND NATURAL RESOURCES

OVERSIGHT HEARINGS ON
FERC ORDER 436

STATEMENT OF CHARLES F. HUGHES, JR.
VICE PRESIDENT OF
OKLAHOMA NATURAL GAS COMPANY
AND ONG TRANSMISSION COMPANY,
DIVISIONS OF ONEOK INC.

NOVEMBER 27, 1985

STATEMENT OF CHARLES F. HUGHES, JR.
VICE PRESIDENT
OKLAHOMA NATURAL GAS COMPANY
AND ONG TRANSMISSION COMPANY

November 27, 1985

I. Introduction.

Mr. Chairman and Members of the Subcommittee:

I am Charles F. Hughes, Jr., Vice President of Oklahoma Natural Gas Company and of ONG Transmission Company, both of which are divisions of ONEOK Inc. Oklahoma Natural Gas Company is a local distribution company that serves over 600,000 customers throughout Oklahoma. ONG Transmission Company is an intrastate pipeline that provides transmission services to move wellhead supplies to Oklahoma Natural Gas Company and to transport gas for third parties under Section 311 of the Natural Gas Policy Act of 1978 ("NGPA"). For ease of reference, I will refer to both corporate divisions as "ONG".

I appreciate this opportunity to appear before you today on behalf of ONG to discuss current problems in the natural gas industry, particularly problems stemming from the new rules issued by the Federal Energy Regulatory Commission ("FERC") in Order 436. Briefly, it is our view that in the commendable pursuit of fostering healthy competition in the natural gas industry, the FERC has issued new rules that have had the opposite effect by disrupting the flow of spot market gas. This has occurred because the interstate pipelines by and large view the new transportation provisions as too onerous to be acceptable and the new environment and its consequences too uncertain at this time. With these concerns, the pipelines are hesitant to make decisions now that may affect them for years to come. There are some positive steps that the FERC can take to remedy this situation, and at this point we believe that the FERC, and not the Congress, is in the best position to deal with the problem. However, we believe that Congress can and should address removal of artificial restraints on natural gas demand imposed by incremental pricing and the Fuel Use Act.

II. Overview.

The last time I appeared before this Committee was in 1983, when the Committee had under consideration a comprehensive natural gas bill proposed by the Administration. At that time the industry was beset with a very serious malady -- *i.e.*, falling demand yet constantly rising gas prices. Great strides have been made since 1983. Natural gas has recaptured and even expanded its market share, and the steady upward momentum of gas prices -- fueled by regulation -- has been broken.

An important element of this evolutionary process has been increased use of transportation arrangements as a complementary alternative to traditional pipeline sales. Before the FERC's new rules governing transportation became effective on November 1, 1985, a healthy spot market for gas had developed. Pipelines, including ONG, were increasingly providing transportation services to assist gas consumers in arranging direct purchases from producers or other nonpipeline gas marketers. In turn, use of such arrangements was playing a key role in assisting pipelines to resolve take-or-pay problems under long-term contracts. According to data provided by the Interstate Natural Gas Association of America, in each of the first two quarters of 1985, interstate pipelines transported more gas for local distribution companies and industrial end-users than in all of 1982. In the second quarter of 1985, pipelines transported almost 215 Bcf of natural gas for distributors and 195 Bcf for end-users. By the end of the second quarter, 16 percent of the total throughput on interstate pipelines was attributable to transportation.

These transportation services were provided under a handful of blanket authorities that permitted parties to buy, sell and transport gas on a self-implementing basis without prior approval from the FERC. ONG has made good use of the transportation authority available under Section 311 of the NGPA, which allows intrastate pipelines to provide transportation service in interstate transactions without jurisdictional consequences under the Natural Gas Act. Indeed, during the third quarter of 1985, ONG transported in excess of 281,000 Mcf per day in Section 311 transactions. In addition, interstate pipelines were providing transportation services under Section 311 and a host of other programs, including special marketing programs ("SMP's"), authorized by the FERC under Section 7 of the Natural Gas Act.

In Order 436 issued October 9, 1985, however, the FERC radically changed the rules governing self-implementing transportation programs. Although individual transactions in effect on October 9 are permitted to be grandfathered subject to certain conditions, the transportation programs under which large volumes of gas had been moving earlier this year have been eliminated and replaced by the new Order 436 transportation rules. Unfortunately, the transition from the earlier, widely-used transportation programs to the new Order 436 regime has not been successful, largely because the new conditions are too onerous to be acceptable to most interstate pipelines.

Under the new rules, interstate pipelines that provide self-implementing transportation service become subject to requirements (1) imposing a so-called nondiscriminatory access condition on all self-implementing transportation service, (2) requiring the pipelines to provide firm as well as interruptible self-implementing transportation service, (3) permitting firm sales customers to abrogate their contracts by reducing purchases from the pipelines or converting to transportation service up to 25 percent per year of their purchase entitlements, and (4) mandating volumetric transportation rates based on projected throughput to become effective by July 1, 1986.

As far as intrastate pipelines go, the Commission correctly retreated in the final rule from imposing requirements for Section 311 transportation that would have resulted in federal regulation of intrastate rates and intrastate service. Thus, the changes facing ONG and other intrastate pipelines center on the requirement of so-called nondiscriminatory access for any and all shippers desiring Section 311 service.

III. Impact of Order 436.

So far ONG has not experienced a dramatic decline in its transportation services. Most of our Section 311 transportation continues as before under the grandfathering provisions of Order 436. However, it is reasonable to expect that transportation service may decline in the future as grandfathered transactions expire and transporters are confronted with difficult decisions whether to subject themselves to the requirements of the new rules. Moreover, although ONG has successfully sought to continue its transportation service and mitigate difficulties for its shippers arising from the transition under Order 436, we have heard reports of producers being shut in at one end of the pipeline and plants complaining about loss of spot market gas at the other end of the pipeline.

IV. Remedial Actions at FERC.

From ONG's perspective, there are positive things that can be done at the FERC to improve the situation, and we have raised our concerns in a petition for rehearing of Order 436. First, ONG has pointed out that the nondiscriminatory access requirement is tantamount to common carriage for Section 311 transportation, which is beyond the Commission's authority under the NGPA. Notwithstanding the Commission's protestations about the "voluntary" nature of transportation under its new rules, these rules operate to convert a pipeline's undertaking to transport gas for an individual customer into a general common carrier obligation to serve all shippers.

Second, ONG has pointed out on rehearing that the "technical corrections order" FERC issued on October 24, 1985, changing the date from which transactions would be grandfathered from November 1, 1985 back to October 9, 1985, constitutes retroactive rulemaking in violation of accepted administrative procedures. By abruptly "ungrandfathering" transactions entered into between October 9 and October 24, 1985, the purported technical corrections disrupted existing contractual relationships and unfairly interfered with arrangements entered into in reliance on Order 436 as it was issued. These substantive changes were instituted without notice or any opportunity for public comment.

As a general matter, the FERC has dealt self-implementing transportation of natural gas a serious blow by imposing conditions on transporters that go far beyond the changes required by the D.C. Circuit in the Maryland People's Counsel cases. The broad sweep of "undue discrimination or preference" outlined in Order 436 can operate to deprive pipelines of their ability to make reasonable business decisions and should therefore be modified. By defining discrimination in categorical terms, such as any refusal to transport natural gas in competition with a pipeline's own sales, the Commission has effectively eliminated a reasonable business judgment test from the criteria used in determining undue discrimination. Unless a pipeline is in a situation where it is economically indifferent whether it transports or sells natural gas to a customer, questions of reasonable business judgment arise whether the refusal to transport amounts to undue discrimination. However, by failing to take into account reasonable business judgment and economic indifference, the FERC has rendered the term "undue discrimination" meaningless. This, in turn, has operated to deter, rather than foster participation in self-implementing transportation programs.

To correct the situation and enable pipelines to deal with their take-or-pay obligations, the FERC should make it clear that "undue discrimination or preference" in Order 436 does not foreclose a pipeline from bargaining for take-or-pay relief in exchange for granting a producer access to transportation. For instance, a pipeline should be able to limit transportation to its existing sales customers to gas released by the pipeline in exchange for take-or-pay relief or, alternatively, if the pipeline transports non-contract gas at the request of a customer, the pipeline should be allowed to include a reasonable take-or-pay carrying charge in its transportation rates. Similarly, the contract demand conversion provision could be made more acceptable if it were limited to permitting the pipeline's firm sales customers to convert to firm transportation of gas released by the pipeline. This concept, of course, is clearly within the FERC's authority and in fact has been successful as a condition to the SMP's.

V. Congressional Action.

Although we wholeheartedly endorse close congressional oversight on natural gas transportation issues through activities like the hearing today, ONG does not believe that Congress should undertake to enact legislation addressing the problems and issues raised by Order 436 at this time. The FERC promulgated the new rules, and the FERC is no doubt equipped to correct the problems that have resulted in a more expeditious fashion than Congress.

Nevertheless, we believe that there are relatively noncontroversial natural gas issues that can appropriately be addressed through legislation at this time. Given the surplus of natural gas that has now been in existence for over four years, it is generally recognized that artifical restraints on natural gas use are inappropriate and counterproductive. Accordingly, we urge the Committee to give serious consideration to legislation repealing incremental pricing of natural gas and the Fuel Use Act's prohibitions on gas use in certain facilities.

I appreciate this opportunity to come before you and welcome any questions you may have.

Senator Nickles. Mr. Hughes, thank you very much. We appreciate your comments on behalf of Oklahoma Natural.

Next we have Mr. Dennis DeLoach, who is vice president of Reliance Pipeline, and speaking on behalf of the Association of Independent Gas Marketers.

Mr. DeLoach.

STATEMENT OF DENNIS DeLOACH, VICE PRESIDENT, RELIANCE PIPELINE, ON BEHALF OF THE ASSOCIATION OF INDEPENDENT GAS MARKETERS

Mr. DeLoach. Mr. Chairman, ladies and gentlemen, I am vice president of Reliance Pipeline. Today, however, I am speaking in the capacity as the director of the Association of Independent Gas Marketers, a national association comprised of companies who market natural gas directly to end users, often using the various intrastate and interstate pipelines as transporters.

My comments today concern the impact of the Federal Energy Regulatory Commission order 436, which was promulgated in an effort to achieve a level playing field, which seems to be tilted, in the interstate market for natural gas.

This was to be accomplished by allowing interstate pipeline companies to voluntarily declare themselves open access transporters of gas on a nondiscriminatory basis.

Since the issuance of order 436 on October 9, 1985, there has been considerable turmoil and uncertainty in the natural gas industry, not to mention the cessation of numerous transactions, mainly all sales to low priority end users and special marketing purchases, SMP.

Member companies of AIGM have been affected greatly by order 436. Individual member companies which had sales in place prior to order 436 had many of those disrupted or canceled, as much as 10 to 70 percent of their total sales, ranging in volumes from approximately 20 million cubic feet per day, up to one 170 million cubic feet per day.

A large portion of these purchases were attributable to Oklahoma producers. This situation has a direct impact not only on the companies which had contracted the end user sales, but also on the producers from whom the gas was purchased, as well as revenues derived by State government for severance and gross production taxes.

AIGM does not have an all-encompassing solution to the problem we are discussing today. However, some actions and revisions which FERC could consider are as follows:

I agree with you, Senator, the Commission or Congress should consider the extension of the initial 45-day transition period which will expire December 15 or 14. AIGM believes that a 6-month extension will allow both pipelines and FERC to sort out some of the problems which have arisen from the order.

This would also give the industry time to digest the full impact of the order.

Two, we feel that the Commission or Congress should recognize that take-or-pay problems present a major obstacle for the pipelines. For instance, a pipeline choosing to participate in transportation is confronted with increased take-or-pay exposure, along with the possibility of reduced sales, and this just cannot happen.

In conclusion, we cannot overemphasize the importance of either the Commission or Congress taking whatever steps are necessary in order to allow transportation accessibility to be available to all shippers. This includes gas marketers.

To the members of the AIGM, it seems like the industry has taken a big step backward under the current order.

Thank you very much.

[The prepared statement of Mr. DeLoach follows:]

STATEMENT OF
DENNIS DELOACH
ON BEHALF OF THE
ASSOCIATION OF INDEPENDENT GAS MARKETERS
BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
NOVEMBER 27, 1985

Mr. Chairman and members of the Subcommittee:

My name is Dennis DeLoach, Vice President of Reliance Pipeline Company. Today, however, I am testifying in my capacity as Interim Director of the Association of Independent Gas Marketers, a national association comprised of companies who market natural gas directly to end users often using the various intrastate and interstate pipelines as transporters.

My comments today concern the impact of the Federal Energy Regulatory Commission's Order 436, which was promulgated in an effort to achieve a "level playing field" in the interstate market for natural gas. This was to be accomplished by allowing interstate pipeline companies to voluntarily declare themselves open-access transporters of gas on a non-discriminatory basis.

Since the issuance of Order 436 on October 9, 1985, there has been considerable turmoil and uncertainty in the natural gas industry, not to mention the cessation of numerous transactions, mainly all sales to low priority end users and special marketing program ("SMP") purchases.

Member companies of AIGM have been affected greatly by Order 436. Individual member companies which had sales in place prior to Order 436 had many of those disrupted or cancelled, as much as 10 to 70 percent of their total sales, ranging in volumes from approximately 20 million cubic feet per day, up to 170 million cubic feet per day. A large portion of these purchases were attributable to Oklahoma producers. This situation has a direct impact not only on the companies which had contracted the end-user sales, but also on the producers from whom the gas was purchased, as well as the revenues derived by the state governments from severance and gross production taxes. This also has an impact on the public with higher energy costs, not only through increased product prices, but also in higher energy bills.

AIGM does not have an all encompassing solution to the problem we are discussing here today. However, some actions and revisions which FERC could consider are as follows:

1. The Commission or Congress should consider the extension of the initial 45-day transition period which will expire December 15. AIGM believes that a 6-month extension would allow both pipelines and the FERC to sort out some of the problems which have arisen from the Order. This would also give the industry time to digest the full impact of the Order.

2. The Commission or Congress should recognize that take-or-pay problems present a major obstacle for pipelines. For instance, a pipeline choosing to participate in transportation is confronted with increased take-or-pay exposure, along with the possibilities of reduced sales.

3. Another aspect of the Order which the Commission or Congress should be aware of is the ability of the pipelines to play a "waiting game". Why should a pipeline become a transporter at this time if it can wait until such time as it is forced to do so by its competition.

In conclusion, we cannot over emphasize the importance of either the Commission or Congress taking whatever steps are necessary in order to allow transportation accessibility to be available to all shippers. To the members of the AIGM, it seems like the industry has taken a big step backward under the current Order.

Senator NICKLES. Mr. DeLoach, thank you very much for your comments.

Our next panelist we have is Mr. J.L. Cox, who is president and CEO of Centrilift-Hughes, speaking on behalf of Petroleum Equipment Suppliers Association.

Mr. Cox.

STATEMENT OF J.L. COX, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CENTRILIFT-HUGHES, ON BEHALF OF E.C. BROUN, JR., PRESIDENT, PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION

Mr. Cox. Thank you, Senator Nickles.

On behalf of Mr. E.C. Broun, Jr., the president of Petroleum Equipment Suppliers Association, we are very pleased this morning to be able to present our views.

Our statement is fairly lengthy and has a number of facts and figures in it. In the interest of time, I want to try to summarize these comments dealing with our concern on the block pricing issue and what we are sure will be the detrimental impact on our customers and subsequently on our industry itself.

In dealing with these realities, we feel that there is a reality that needs to be currently faced, and that is the one that the Nation's oil and gas equipment manufacturing, field service, and supply companies are facing.

These companies do not produce a single MCF of natural gas, but our livelihood depends on serving those companies that do.

As an illustration, in 1984 sales of our industry were approximately $33 billion, earnings of less than $1 billion. If you exclude one company, Schlumberger, which is a French-owned company based in the Netherlands Antilles, the industry's earnings would be a negative $100 million.

Approximately one-third or 10 million of those sales were generated from overseas projects. In the process the industry furnished employment to people in some 46 States.

If you compare these numbers to the industry's 1981 numbers, sales were $41 billion, $6.2 billion in earnings, some $16 billion in foreign sales and we employed over one-half a million people.

As an industry, we are currently striving under very detrimental conditions to maintain our technology competitive edge and we sincerely hope that we do not lose this edge by exporting our technology, as some of our other basic industries in this country has had to do.

We are fighting today to stay alive. We are asking for your committee's understanding of this issue.

The separation of old and new gas, we realize, will bring tremendous pressure on the price of new gas, and it will no doubt force it below the cost to drill and develop new reserves. As this happens, drilling budgets will shrink and the companies in our industry will be forced to contract further and additional ones will be forced out of business.

It is in our interest to continue blended gas pricing. However, we believe that it is just as clearly in the long-term interest of the Nation.

As the past has proven, the short-term gains for the consumer is by far more than offset in the long-term cost.

In the 10 years from 1972 to 1982 the manufacturers of petroleum equipment companies invested more than $3.6 billion in new plant and equipment. This was in response to the demand resulting from the oil embargo and our dependence on foreign energy and our industry expanded at an annual growth rate of some 32.4 percent.

It is interesting to note that this exceeded the 25-percent compounded annual growth rate in sales over the same period.

Today we are still dependent on foreign sources for approximately one-third of our energy needs. This is about the same that existed prior to the 1972 embargo.

Should a similar disruption occur in the future, we may not have the luxury of 10 years to catch up. Our industry has already lost approximately one-half of its work force and much of its manufacturing facilities and equipment.

Almost every company has experienced and/or continues to experience heavy financial losses. In the past 3 years we have written off between $2 and $3 billion in assets and facilities. We have lost experienced people and facilities that will not be easy to replace when our industry is called upon to gear up once again.

We are concerned that what the Commission proposes will lead to a misguided convulsion of consumerism, looking to the short term of low-cost natural gas, but will ignore the long-term impact of shortages and the long term interests of the consumer.

Feast today and famine tomorrow will not today, as it has not in the past and will not in the future, serve the American public. We believe that this is where block pricing decisions will take us.

As an appendix to our statement, we have attached a thoughtful discussion of the current natural gas surplus, as analyzed by Mr. Fred Z. Mills, Jr., of Petroleum Data Perspectives, Inc., of Dallas, TX.

Mr. Mills is an industry analyst and economist with a wide following in our industry and among various financial institutions serving our industry. Mr. Mills says we are rapidly heading toward a gas shortage, a mild one in 1986, a more severe one in 1987, and a major one in 1988.

He points out that in the period of 1978 to 1981, the industry failed to heed warnings of an approaching surplus that was being provided by the trend of collapsing total demand. He wonders now if the industry and the FERC will fail to heed the warnings of an approaching shortage provided by the new trend of declining gas deliverability.

It is our contention that block pricing will exacerbate this situation.

Senator, the details in this statement point out the shocking condition of an industry that has served its customers and this country well for many, many years.

We have had many ups and downs and we will bounce back when the need arises again in the future; but if this situation continues, and even worse, is aggravated by meddling in the marketplace, however well intentioned, the rebound may not be soon enough or great enough to not have a major detrimental impact on our customers and ultimately the consumers of the oil and natural gas consumed in this country.

We appreciate very much your efforts in helping to bring some sanity to this situation and wish you every success, and pledge you our interest and our help in trying to eliminate this disastrous effect that will come from block pricing.

Thank you very much.

[The prepared statement of Mr. Cox follows:]

**Petroleum
Equipment
Suppliers
Association**

9225 Katy Freeway Suite 401
Houston, Texas 77024
713/932-0168

Statement

Of

J. L. Cox

Centrilift-Hughes

On Behalf of

E. C. Broun, Jr.

Petroleum Equipment Suppliers Association

Before the

Subcommittee on Energy Regulation and Conservation

Of the

Committee on Energy and Natural Resources

U.S. Senate

Tulsa, Oklahoma

November 27, 1985

The Commission is to be commended for recognizing the new reality of the natural gas pricing and transportation. Clearly, market conditions today bear little resemblence to those existing only three or four years ago.

There is another set of realities, however, that we believe should have an equal bearing on the Commission's decision with respect to block pricing. These are the realities currently faced by the nation's oil manufacturing, field service and supply companies. These companies do not produce an MCF of natural gas, but our livelihood depends on serving those companies that do.

In 1984, industry sales were $33 billion with earnings of less than $1 billion. Excluding Schlumberger, a French company based in the Netherlands Antilles, the earnings of the industry were a negative $100 million. Roughly one third of the industry's sales, approximately $10 billion, were generated from overseas projects. In the process the industry furnished employment to people in 46 states.

This is a far cry from the industry's 1981 numbers: $41 billion in sales, $6.2 billion in earnings, $16 billion in foreign sales and a work force of 500,000.

The industry is striving to maintain its technology competitive edge and hopefully it will not have to erode its edge by exporting technology as the steel industry and some other basic industries have had to do. We need the Commission's understanding of this issue.

The separation of old and new gas will bring tremendous pressure on the price of new gas, forcing it below the cost to drill and develop new reserves. Under these conditions drilling budgets will shrink and the companies in our industry will contract further and some will go out of business.

It is clearly in the interest of the industry to continue blended gas pricing. However, it is just as clearly in the national interest. Drilling for natural gas is a complex, highly technical and expensive business. The degree of research and technology which natural gas exploration entails is illustrated by the following set of numbers.

In the period of 1972-1982, the manufacturers of petroleum equipment invested more than $3.6 billion in new plant and equipment. Responding to the oil embargo and the increased demands of our customers, the industry sustained a compound annual growth rate of 32.4 percent in those ten years. It is interesting to note that this rate exceeded the 25 percent compound growth in sales for the same period. Today America is dependent on foreign sources for approximately one third of its energy needs. This is roughly the same dependency that existed prior to the 1972 oil embargo. Should a similar disruption occur in the future, the nation may not have the luxury of ten years' time to allow the industry to catch up with the market.

Recently I compiled and analyzed some data on the impact that the dramatic drop in oil and gas prices has had on our industry. I have included this analysis as item 2 in the appendix to my statement.

As indicated above, the oil field service industrv has already lost half its work force in the last three years. The experience of these hundreds of thousands of trained men and women will not be easy to replace when the industry is called upon to gear up.

The table below illustrates the losses experienced by the oil industry in both personnel and equipment utilization. Employment has dropped 33% from its high in 1982, and over 30% of the rigs available for offshore drilling in the U.S. Gulf sit idle.

Oilfield Employment *	All Time High March '82	May '83	May '84	May '85
SIC #3533	139,000	69,500	64,500	65,200
SIC #138	479,900	319,300	335,500	352,100
U. S. Gulf Rig Utilization**	100% (Jan '82)	65%	80%	69.2 (July '85)

*Employment numbers from Bureau of Labor Statistics and are for SIC Codes #3533 and #138 and do not include supply segment personnel.

**Offshore Data Services, Houston, Texas.

The market has sent the oil field service industry a clear signal that the demand for its products has contracted and the industry has responded. A radical departure from the environment that generated this signal could well create further dislocations by putting still more pressure on the price of new gas. When the market turns around, as it has countless times in the past, the oil field service industry will respond but not without considerable problems for our customers and, eventually, the consumer.

Energy policy requires statesmen who see long range requirements and are willing to act accordingly. What the Commission proposes to do is to pass its pricing authority to a proliferation of state utility boards. These groups in a misguided convulsion of consumerism will cast their lot with low cost natural gas. The fact that the local utility groups will have no concern for supply beyond the immediate will result in short range, expedient decisions which ignore future impacts. Block pricing will care for the consumer's needs for the near term. We question the ability of the local utility companies to properly function in a manner which will protect the long term interest of the customers. Truly, we all recognize the merits of an immediate low price to the consumer, however, part of the true price equation should include consideration of future sources of supply. Feast today and famine in the future will not serve the American public and we believe that this is exactly where the Commission's block pricing decision will take us.

As an appendix, we are attaching a thoughtful discussion of the current natural gas surplus as analyzed by Fred Z. Mills, Jr. of Petroleum Data Perspectives, Inc. Dallas, Texas, an industry analyst and economist with a wide following both in the petroleum equipment and service industry and among financial institutions serving this industry. Mr. Mills documents what he believes to be a very near term shrinking of the gas surplus. We believe that this data deserves serious consideration, because the proposed block billing regulations assume low return on investment to the operator. This is the same operator who will be expected to invest funds in the search for new natural gas reserves. Can he be expected to do so in the face of high risk and subnormal payout expectations?

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Equipment
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The U. S. Natural Gas Surplus

Fred Z. Mills, Jr.

Petroleum Data Perspectives, Inc.

November 13, 1985

Attachment # 1

The U. S. Gas Surplus

Over the early 1970's, the U. S. capacity to supply natural gas declined severely causing consumption to fall. Meanwhile, despite rapidly rising gas prices, demand for gas was steady because gas remained a bargain fuel, even though the size of this bargain was diminishing fast. Because of this steady demand and falling capacity, an initally small gas shortage, representing that portion of demand that could not be satisfied, became progressively larger, and reached a peak of about 9 BCF/Day in 1977. Then two things happened.

First, continuing jumps in the price of gas eliminated its status as a bargain fuel, causing demand to begin to plummet in 1978--a nosedive that continued for five years and amounted to a cumulative decline in demand of 16 BCF per day. This decline was largely unnoticed until 1981, three years after it began, because the decline in demand that had occurred over the 1978-1980 period did not show up in the form of reduced gas consumption. Instead, it showed up as a reduction in the total of gas consumption plus curtailments of gas sales to end users. Consumption represents the satisfied portion of demand. Curtailments represent the unsatisfied portion of demand. Unsatisfied demand was collapsing at a faster rate than consumption was growing. This consumption growth after 1977 was the result of the second thing that began to happen in 1978.

The capacity to supply gas, that had collapsed in the early 70's and had flattened in 1975, began to grow in 1978, the product of the gas drilling boom that had been underway since 1971. Between 1977 and 1984, the capacity to supply gas in the U.S. expanded 6 BCF per day, 5 of which had been achieved by 1983.

To summarize what happened between 1977 and 1983:

We had a gas shortage of 9 BCF per day in 1977. Between then and 1983, the shortage was reduced 5 BCF per day by increased capacity and was reduced another 16 BCF per day by reduced demand--a total reduction of the shortage of 21 BCF per day from a base of 9 BCF per day. This left the U.S. with a negative shortage of 12 BCF per day in 1983. A negative shortage is, of course, a positive surplus.

In 1984 demand for gas both from end users and from the underground storage system grew. Because of the surplus, virtually all of this 1984 demand was satisfied, as domestic production grew by 3.3 BCF per day. The capacity to produce gas also grew, by 0.8 BCF per day. Therefore, the gas surplus was reduced by 2.5 BCF per day, leaving the U.S. with an average surplus of 9.5 BCF per day in 1984. During 1984, the production of gas averaged 49.4 BCF per day while the capacity to produce gas averaged 58.9 BCF per day.

Since 1982, a very important pattern has developed in the trend of production capacity. In 1983, production capacity increased 4% or 2.2 BCF per day. In 1984, production capacity increased only 1.5% or 0.8 BCF per day. Comparing the first 8 months of 1985 with the first 8 months of 1984, average capacity declined 3.5% or 2.1 BCF per day. Comparing the single month of August 1985 with the same month last year, average capacity to produce gas declined 6% or 3.5 BCF per day. Thus, we have seen a pattern over recent periods in which gas deliverability first began to experience a slower rate of growth, then began to decline, and now is declining at an accelerating rate. During August, estimated deliverability was less than 55 BCF per day. During the first half of 1984, it had averaged 60 BCF per day.

In August of this year, the estimated deliverability surplus was estimated at 9.5 BCF per day, down about 0.7 BCF from last August, but equal to the 1984 average surplus. In evaluating the current surplus, it is important to note that gas production has become seasonal. The underground storage system accommodates almost all of the swings in seasonal demand when a gas shortage exists. But when a surplus is present, and as transmission and market bottlenecks have been eased by contract carriage and the spot market, a growing percentage of seasonal demand has been met by stepped-up production from primary gas reservoirs rather than by withdrawals from gas storage. While this shift away from the gas storage system that occurs during a surplus does not usually have a major impact on a full-year's production or average surplus, it does have a large impact on the seasonal production pattern and also on the year-to-year comparisons both of monthly production rates and of the gas surplus.

For example, August is one of the months when large quantities of gas are produced from primary reservoirs for injection into underground storage. In August 1984, these injections were at the rate of 9.1 BCF per day. In August 1985, the injection rate was only 7.3 BCF per day. If instead this year's August injection rate had matched last year's, the surplus in August 1985 would have been only 7.7 BCF per day rather than 9.5. The year-to-year surplus would have declined by 24% or 2.5 BCF per day, rather that 6.4% or 0.7 BCF per day. Less storage today means more prodution this winter. The gas not produced for storage does not mean lost revenues, merely deferred revenues, provided that essentially all of the winter's demand can be met by the combination of production and storage withdrawals.

Therefore, when adjusted to eliminate the change in the rate of storage injection, the normalized rate at which the surplus declined in the August comparison was 2.5 BCF per day, caused by a 3.5 BCF per day decline in deliverability that was partly offset by a 1 BCF per day decline in demand from end users.

With the trend of rapid and accelerating declines of deliverability, we are moving headlong toward a gas shortage. In January of this year, gas production hit 56 BCF per day. In the previous winter, production peaked at 58 BCF per day. With current production capacity indicated at only 55 BCF per day and falling, the gas storage system may have to deliver more gas this winter than perhaps has been expected. It can probably handle this winter's demand. But what about next winter and particularly the one following? If the declining trend of deliverability doesn't eliminate the surplus, block billing and tax changes will. Add to this the outlook for growing gas demand that should accompany lower gas prices, and the additional demand that will come from the U.S. industrial sector as our trade imbalance improves. We are rapidly heading toward a gas shortage, perhaps a mild one next year, a more severe one the following year, and a major one the year after that.

From 1978 to 1981, the industry failed to heed the warning of an approaching gas surplus that was being provided by the trend of collapsing total gas demand. Will the industry, as well as FERC, now fail to heed the announcement of an approaching gas shortage being provided by the new trend of declining gas deliverability?

The Impact of the Decline in Drilling Activity on the Oil Field Service Industry

E. C. Broun, Jr.

Hughes Tool Company

November 12, 1985

Attachment #2

We've all been subjected for the past three years to explanations of the causes of the decline in drilling in the U.S. and I think most of us expect, barring dramatic events in the middle east or unlikely legislative incentives, that our industry will be flat at best for the next two or three years.

I would like to illustrate what the impact of the decline has been on the energy service industry - in terms of financial performance and the internal and external reorganizations that companies have had to undergo as they size themselves to meet shrinking markets.

Chart #1 is a condensed history of the U.S. drilling industry for the past 4 years and nine months. Although we have all heard enough about the rig count, my purpose in showing this chart is to illustrate that we are not yet upon the usual seasonal upturn.

At a time when the rig count is normally "going north", you see that we are still "going south and east".

Few of us thought the average rig count through the first ten months of 1985 would be 161 rigs shy of what it was in 1983, and 394 below the average for 1984.

The toll exacted on the industry's sales and earnings has been as drastic as the decline in drilling. As the rig count demonstrates, our markets have been cut almost in half since 1981. . . . compounding shrinking sales has been the specter of overcapacity and massive excessive inventories which resulted from our determination to meet what most of us thought would be an active rig fleet of between four and five thousand.

Not only did these factors foster price discounting, but the industry has also been forced to take write-offs that total in the 10 figures - between two and three billion dollars in the last three years.

The companies shown on chart 2 without exception, have incurred losses either in '83 or '84, or they're projected to take losses in 1985 - for some, it's all of the above!

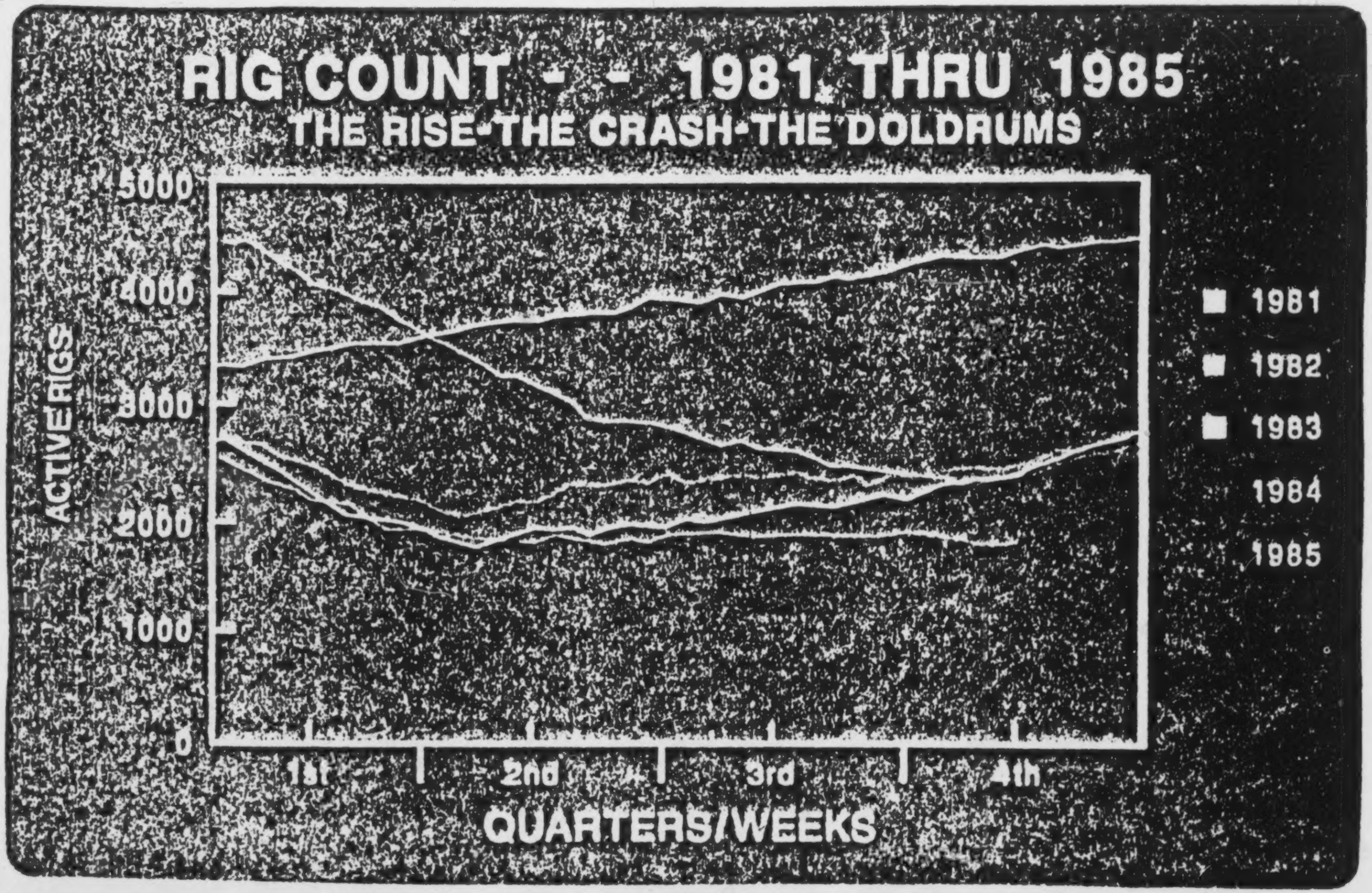
I should point out that 1985 estimates shown here are from industry analysts.

As we've seen, the circumstances of the past three years have caused disruption to the industry on a scale never seen before. The decline in the U.S. drilling industry has required a number of strategic moves in the past two years to cope with new market conditions. In addition to writedowns and internal consolidations at individual companies, the industry has also undertaken acquisitions, divestitures, and partnerships or joint ventures to redeploy its assets as charts 3,4 and 5 show.

While the recent period has been highly traumatic, and while we can never expect the euphoria of the '79 - '81 period again, I am optimistic that the oilfield services and equipment industry will continue to be a viable industry - and will again be a successful one. We're proving we can be efficient. . . . that we can size ourselves to meet current markets . . . . that we can reorganize and reduce our costs. . . .that we can compete.

Mr. L. G. Rawl, President of Exxon Corporation, pointed out that restructuring is taking place in many U.S. industries today. To quote Mr. Rawl:

"The petroleum industry is going through its own shakeout and, as in others, there'll be winners, losers, and battle-hardened survivors. But that's nothing new for our industry. We've known tough times before - and we've always bounced back."



RIG COUNT - - 1981 THRU 1985

THE RISE-THE CRASH-THE DOLDRUMS

Chart 2

OIL SERVICE COMPANY NET INCOME OR (LOSS) - $000

Company	1981	1982	1983	1984	1985 E
Baker Intl	225,000	248,600	(63,500)	70,600	90,000
EPS	3.36	3.60	(0.91)	1.00	1.25
Cameron Iron	109,996	152,583	3,335	(178,645)	3,683 A
EPS	3.62	5.02	0.11	(5.89)	.12 A
Dresser Ind	316,600	172,300	5,100	96,700	
(4/30) EPS	4.04	2.19	0.06	1.24	(2.40)
Galveston/	22,611	309	(35,464)	(13,741)	
HoustonEPS	4.02	0.67	(6.08)	(1.77)	(0.50)
Gearhart Ind	26,633	31,647	15,960	6,742	
(4/30) EPS	1.84	2.05	1.03	.40	(0.20)
Halliburton	674,300	496,800	322,000	329,600	
EPS	5.72	4.34	2.68	1.87	(2.40)
Hughes Tool					
EPS	4.69	2.65	(1.64)	(2.40)	.10
NL Ind (1)	254,368	185,274	(47,239)	(132,735)	
EPS	3.76	2.84	(0.83)	(2.20)	.35
Smith Intl	133,116	82,310	(94,533)	(68,451)	
EPS	5.80	3.61	(4.17)	(3.01)	(2.75)
Varco Intl	22,300	(17,200)	(11,800)	(17,800)	
EPS	2.01	(1.57)	(1.10)	(1.69)	(0.30)
Weatherford	24,468	1,710	(22,796)	(23,551)	
Intl EPS	2.82	.20	(.264)	(2.91)	.15
Western Co	101,376	56,650	(22,461)	(14,553)	
of N.A.EPS	2.28	1.27	(.67)	(.49)	(1.65)

E - Estimated (Salomon Bros., Paine Webber, Alex Brown, Drexel Burnham, WSJ)
(1) - From continuing operations

Chart 3

ACQUISITIONS

	Business	
Drilling & Service (D&S) Ltd. by NL Industries (Hycalog)	Stratapax Bits (North Sea Market)	11/82
American Coldset by Baker Intl (Reed Rockbit)	Diamond Bits	07/83
Solus Ocean Systems by Oceaneering, Inc.	Offshore Services	10/83
Core Laboratories by Litton Industries	Core Analysis & Reservoir Engineering	01/84
Teleco by Sonat	Directional Drilling	02/84
Geosource by Gearhart Industries	Seismic	07/84
Digicon (40%) by NL Industries	Seismic	08/84
Petrolane by Texas Eastern	Oilfield Services/ Directional Drilling	12/84
Sedco by Schlumberger	Offshore Drilling	12/84

Chart 4

DIVESTITURES

	Business	Date
NL Industries	Oil Well Servicing	05/84
Baker International	Downhole Pump Systems	05/84
Galveston-Houston	Tongs/Chokes	07/84
Northwest Industries	Tubulars	09/84
Hughes Tool	Fishing Tools Snubbing Services Drillstem Testing Subsea Pipeline Connectors Corrosion Monitoring	83 - 85
Dresser Industries	Oilfield Chemicals	11/84
Varco International	Electronics	12/84
Crutcher Resources	Rental Tools	12/84
CMI Corporation	Oilwell Pumping Units	12/84
Weatherford International	Rental Tools	04/85
GEO International	Tubing Conveyed Perforating	08/85

Chart 5

PARTNERSHIPS AND JOINT VENTURES

	Business	Closed
Grace-DMI/Hughes Drilling Fluids	Drilling Mud	12/83
Dowell/Schlumberger	Pumping Services	01/84
NL Reamco/G-H Drilling Services	Downhole Rentals	04/84
Hughes Tool/Nippon Steel	Tubulars	05/84
Dresser Guiberson/Cameo	Marketing Agreement	05/84
Dresser Titan/Geosource Geofrac	Pumping Services	07/84
Zapata Marine/Howco Gulf Fleet/HNG Jackson	Supply Boats	11/84
Howco-Taylor/Wharton Williams	Offshore Diving Svcs	11/84
BJ-Hughes/Titan Services	Pumping Services	04/85
Dresser-Ideco/Ingersoll Rand-Cabot	Drilling Equipment	07/85
Weatherford/Petrolane-DTI	Rental Services	04/85
Triumph/Newpark LOR	Downhole Rentals	09/85
Baker Milchem/Newpark Resources	Drilling Mud	10/85
NL Acme/Enterra Oilfield Rental	Rental Services	11/85

Senator Nickles. Mr. Cox, thank you very much for your comments.

Our final panelist on this panel is Mr. William Robins, who is regional vice president of Halliburton.

STATEMENT OF WILLIAM E. ROBINS, JR., REGIONAL VICE PRESIDENT, HALLIBURTON SERVICES

Mr. Robins. I am with Halliburton. I office at Tulsa and I am vice president of operations in the northern part of the State.

Our oilfield services group is a major provider of products and services, both onshore and offshore, for the exploration and production segments of the petroleum industry.

Halliburton's qualifications to speak on oil and gas issues are well established. The big red truck is a recognized landmark anyplace where oil and gas operations are in progress.

Today I want to talk about the impact on Halliburton and the oilfield service industry of the FERC's order No. 436 and revised proposal on block billing.

First of all, I would like to endorse and reinforce the comments of Mr. Cox with the Petroleum Equipment Suppliers Association of which we are members.

In the 6 months since the original proposed rulemaking, volumes have been written about the predictable adverse impacts on natural gas production. The avowed purpose of NOPR 84-1 was to make natural gas cheaper for the consumer at the burner tip. Short term, with questions, this may occur, but the long-term results are much less predictable.

An unfortunate aspect of the proposal is that oil and natural gas drilling rates are already falling rapidly due to surpluses and problems over the various tax proposals.

The FERC action will further accelerate the drop in drilling activity at a time when the best interests of the Nation and the economy would be served by stability of price structure and employment.

The statistics in the PESA testimony tell the grim story of what has happened to the oilfield service business and the end is not in sight.

In our own company, Halliburton, for instance, the oilfield service divisions have gone from a high of 32,000 domestic employees in 1982 to a present roster of about 18,000. This is a 40-percent drop.

The ability to produce and supply energy in this country should be regarded as a national security factor, but it is certainly not being treated that way. All we want is relative stability and freedom from overregulation.

If there is one factor that can further aggravate the economy with a potential of putting the country into a recession, it is fluctuating energy prices. The Government's attempt to regulate and influence these costs is our greatest source of concern. Price regulation has always been counterproductive.

If we could anticipate a permanent reduction in the need for natural gas, these rulings would make some sense; but we all know that once the cheap gas is used up, and it will be at an accelerated rate under block pricing, we will have to go back out to find and produce more new natural gas.

This time it will be at a much higher price. It is this yo-yoing of prices and demand that is so devastating.

Our industry is made up of highly trained professionals and the leadtime to obtain qualified oilfield service workers is such that we cannot always respond quickly. We have to manufacture specialized equipment and we have to train our employees to perform these highly technical services.

One other aspect of the requirment for stability that is not generally considered is the need for a predictable cash flow to support the research necessary to develop the skills and techniques that keep us competitive worldwide.

The skills we develop and sustain in a stable domestic market are exportable and help to counter the growing trade imbalance. Our company operates in over 80 foreign countries.

When we weaken our domestic base, we also run the risk of losing dominance in a broad range of very marketable, exportable, petroleum-related technologies. We are inhibiting development of the experience and know-how that will contribute to our energy independence.

There is an obvious and much more desirable alternative to the block pricing proposal that would probably achieve almost the same short-term results without the long-term adverse backlash: Decontrol natural gas completely at the wellhead.

This, of course, has been a long-sought goal of the industry. It was achieved under the current administration's leadership for oil and the effort should now be accelerated for natural gas.

The crisis that is predicted for our industry and the Nation as a result of tax reform and block pricing adds impetus to the need for deregulation. The time has never been more appropriate.

Decontrol, incidentally, is a desire of the Department of Energy, announced in San Francisco recently by Secretary John Herrington.

In summary, the oilfield services group is a unique segment of the industry. Its existence is a national resource which contributes greatly to our security. All we ask is a chance to retain reasonable stability in energy production and pricing. In our view, the FERC's block pricing initiative will not achieve this.

The only logical solution to our dilemma would be total decontrol of all natural gas at the wellhead.

Thank you very much.

[The prepared statement of Mr. Robins follows:]

TESTIMONY FOR BILL ROBINS, DUNCAN

SENATE ENERGY AND NATURAL RESOURCES SUBCOMMITTEE ON
ENERGY REGULATION & CONSERVATION
Tulsa, Oklahoma - Nov. 27, 1985

HALLIBURTON SERVICES

My name is William E. Robins, Jr. I am Regional Vice President for the northern part of the United States, responsible for Halliburton Services' operations in a multi-state area, ranging from Pennsylvania to Oklahoma. The oil field services group is a major provider of products and services, both onshore and offshore, for the exploration and production segments of the petroleum industry. Halliburton's qualifications to speak on oil and gas issues are well established. The "Big Red" truck is a recognized landmark any place where oil and gas operations are in progress.

Today I want to talk about the impact on Halliburton and the oil field service industry of FERC's October 9th, 1985, Order No. 436 and revised proposal on block billing. First of all, I would like to wholeheartedly endorse and reinforce the comments of J. L. Cox, who testified for the Petroleum Equipment Suppliers Association, of which we are members. In discussing these impacts, I will amplify PESA's remarks. In the six months since the original proposed rulemaking, volumes have been written about the predictable adverse impact on natural gas production. I think we can almost accept this as inevitable. The avowed purpose of NOPR 85-1 was to make natural gas cheaper for the consumer at the burner tip. Short term, to a questionable extent, since FERC doesn't control distribution company prices, this may occur. But the long term results are much less predictable. An unfortunate aspect of the proposal is that oil and natural gas drilling rates are already falling rapidly due to surpluses and uncertainty over the various tax proposals. The FERC action will further accelerate the drop in drilling activity -- at a time when the best interests of the nation and the economy would be served by stability of price structure and employment. These needs should transcend any hypothetical short range -- and probably short lived -- decrease in utility price to consumers.

For some reason, between tax reform proposals and the FERC rulemaking, the U. S. government seems determined to cripple another major U. S. industry -- joining the smokestack industries. The statistics in the PESA testimony tell the grim story of what has happened to the oil field service business, and the end is not in sight. In our own company, Halliburton, for instance, the oil field service divisions, have gone from a high of over 32,000 domestic employees in 1982 to a present roster of about 18,000. This is a forty percent drop.

The ability to produce and supply energy in this country should be regarded as a national security factor, but it is certainly not being treated that way. We are not asking for subsidies; all we want is relative stability and freedom from over-regulation. If there is one factor that can further aggravate the economy with a potential of putting the country into a recession, it is fluctuating energy prices -- witness how nervous Wall Street gets when OPEC meets. The government's attempt to regulate and influence these costs is our greatest source of concern. Price regulation has always been counterproductive, but we never seem to learn this lesson

If we could anticipate a permanent reduction in the need for natural gas, these rulings would make some sense, but we all know that once the cheap gas is used up -- and it will be at an accelerated rate under block pricing -- we will have to go back out to find and produce more new natural gas. This time it will be at a much higher price, as demand will have been inflated by the artificially lowered prices and production costs will increase for start-ups. It is this yo-yoing of prices and demand that is so devastating.

Our industry is made up of highly-trained professionals, and the lead time to obtain qualified oil field service workers is such that we cannot always respond quickly. We have to manufacture specialized equipment, and we have to train our employees to perform these highly technical services.

One other aspect of the requirement for stability that is not generally considered is the need for a predictable cash flow to support the research necessary to develop the skills and techniques that keep us competitive worldwide. This is an additional element of the problem that should be taken into account.

The skills we develop and sustain in a stable domestic market are exportable and help to counter the growing trade imbalance. Our company operates in over 80 foreign countries. When we weaken our domestic base, we also run the risk of losing dominance in a broad range of very marketable exportable petroleum-related technologies. We are inhibiting development of the experience and know-how that will contribute to our energy independence and also help to bring petro dollars back to the United States.

There is an obvious and much more desirable alternative to the block pricing proposal that would probably achieve almost the same short-term results without the long-term adverse backlash: decontrol natural gas completely, at the wellhead. This, of course, has been a long-sought goal of the industry. It was achieved under the current Administration's leadership for oil, and the effort should now be accelerated for natural gas. The crisis that is predicted for our industry and the nation as a result of tax "reform" and block pricing adds impetus to the need for deregulation. The time has never been more appropriate. While energy prices are still reasonably low; while there is still a surplus; and while we have an administration that is generally receptive to decontrol initiatives, we should be moving toward this goal. This, incidentally, is a desire of the Department of Energy announced in San Francisco last week by Secretary John Herrington.

In summary, the oil field services group is a unique but endangered segment of the industry. It's existence is a national resource which contributes greatly to our security. All we ask is a chance to retain reasonable stability in energy production and pricing. In our view, the FERC's block pricing initiative will not achieve this and is, in fact, counterproductive. The only logical solution to our dilemma would be total decontrol of all natural gas at the wellhead.

I thank you for this opportunity to appear, and will answer any questions.

* * * * * *

Senator **Nickles**. Mr. Robins, thank you very much.

I was in Duncan recently. How much is employment off at the Duncan facility? Do you happen to know?

Mr. **Robins**. We have approximately 2,900 in Duncan and an additional 325 at our manufacturing center in Davis and then about 1,000 out in the field in Oklahoma.

Senator **Nickles**. Is that off 40 percent as well?

Mr. **Robins**. Yes.

Senator **Nickles**. Mr. Cox, I had the pleasure of being at your plant not too long ago, too.

How is your employment picture at Centrilift-Hughes?

Mr. **Cox**. At Centrilift-Hughes our employment is about the same. It is down slightly from what it was in 1982, but we have not been impacted as heavily as have our drilling operations.

Senator **Nickles**. How heavy would it be in——

Mr. **Cox**. In the Hughes Tool Co., totally, employment is down from a high of about 19,000 to around 9,000 to 10,000 now, so about half.

We have closed eight manufacturing facilities, two in the last 3 weeks. It is a very detrimental situation right now, Senator.

Senator **Nickles**. I appreciate your comments.

We had some outstanding statements, and I will address this more to our pipeline panelists.

I was impressed by some of the comments that there is a willingness to try to find some common ground to restore some common sense to a very chaotic market. I think we did hear from both our producing panel and our pipeline panel some things in common that maybe we will be able to move forward in that regard.

I think it was mentioned by several panelists that there had been on a voluntary basis under the rules preceding 426 that allowed gas movements, and that was increasing substantially, was it not, over the last couple of years; is that correct?

Mr. **Kalen**. That is correct.

Senator **Nickles**. From maybe, what, a zero percent or a very small percent a few years ago, to, what, a 15 percent for Northwest Central in spot——

Mr. **Bailey**. We were at 15 percent. I think the statistics suggest the industry as a whole for that type of transportation was at about 16 percent in the second quarter.

Senator **Nickles**. So, 16 percent?

Mr. Kalen.

Mr. **Kalen**. We were up—29 percent of our throughput in the first 9 months of this year was transportation.

Senator **Nickles**. Is that Panhandle and Trunkline?

Mr. **Kalen**. Panhandle and Trunkline, yes, sir.

Senator **Nickles**. Is it greater on one or the other?

Mr. **Kalen**. Yes; it is greater probably on Panhandle than it is Trunkline.

Senator **Nickles**. Is there much difference between Northwest and Northwest Central?

Mr. **Bailey**. Well, Northwest Pipeline has a higher percentage of transportation, but they also have a form of transportation that has traditionally been exercised in business and that is associated with exchange transactions and there is a transportation element to that. They would have a fairly high level of that.

Senator NICKLES. Mr. Kalen, you mentioned 29 percent, which is a lot more than most pipelines.

Have you been aggressively seeking it or have you just been willing to move the gas?

Mr. KALEN. No, sir; we were one of the few pipeline companies that did have a special marketing program in place, and I would like to mention that during the past summer of 1985, the special marketing program was such that a local distribution company could nominate 10 percent of his contract demand, not his requirements, but the contract demand for transportation.

By then doing this in the summer months when their requirements are very low, it amounted to almost, as I recall, 40 percent perhaps of their requirements.

Our requirements for resale gas in the summer months got so low that we were even unable to produce casinghead gas. So, we were threatened with shutting in oil production, and so forth and so on. At that time we came up with a special program to encourage our customers to get back on. But that is what can happen to you when you open the system up.

There is no stop. It can go and go and go and it is a very difficult situation. Then, of course, when the cold weather hits, for example, we had the temperature on our system drop 40 degrees last week. Our entire requirement from customers doubled in their takes in 24 hours.

If it had not been for diverse supply on the pipeline system and storage capabilities and everything, we would not have been able to take that kind of a wing-in load on our system.

Senator NICKLES. Just from this last cold front?

Mr. KALEN. That is right.

Senator NICKLES. That is an interesting comment. The cold front just hit here.

Mr. KALEN. Indianapolis, IN, for example, was taking 70 million a day and went to 220 million in 24 hours off the pipeline.

Senator NICKLES. That is remarkable.

Mr. Harbor, what percent is El Paso moving now?

Mr. HARBOR. On average we are moving about 20 percent, or have been moving about 20 percent. It has gone up, on a daily basis, over 700 million cubic feet a day, spot sales in the market.

Senator NICKLES. What happened to your two big California customers that were buying that spot gas in that 7-day period?

Mr. HARBOR. They were terminated until we could get a clarification of the ruling out of the FERC. When the order came out, it was very unclear as to where pipelines would stand with respect to whether if they continued their present transportation arrangements, would they be irrevocably committing themselves to becoming a transporter.

At that point there were just too many unanswered questions between we and our customers, between what we wanted and what they wanted and we did not want to cross that bridge. So, we were not ready to become an open access transporter.

We were concerned if we continued our spot arrangements, that we could subject ourselves to that. So, we immediately sought clarification from FERC to have them tell us that we would not subject ourselves to that and they ultimately did that. As soon as we got that word, we immediately recommenced that same service. It is continuing today and will continue into the indefinite future.

Senator **Nickles**. What was it, Southern California Gas and Pacific Gas & Electric?

What did they do in that intervening period? Did they have storage?

Mr. **Harbor**. No. They purchased system supply gas from us. There is really just so much market out there and the spot gas was simply displacing El Paso system supply gas.

The market was the same. All we were doing was just trading between producers. We shut our producers in and turned the spot producers on.

Let us say in Oklahoma, we can move, I would say, 400 to 500 million a day out of Oklahoma. The system is running pretty much at capacity.

When we turn on the spot gas, we shut in the system supply gas which is also Oklahoma gas. So, it is sort of a Hobson's choice, it seems to me, as far as the producers are concerned.

Senator **Nickles**. I think both Mr. Bailey and Mr. Kalen mentioned that same thing. I do not want to put words in your mouth, but would it be correct to say that there was not a decrease in total volumes of gas going to your customers, but you are making it in firm sales instead of moving it in transportation?

Mr. **Harbor**. That is correct.

Mr. **Bailey**. On that basis, when we see the aggregate statistics, there will be very little change in the total gas that moved; but the individual disruptions, obviously, are substantial.

Senator **Nickles**. I do not know how easy that would be to monitor due to the fluctuations and weather, and so on. We have the gross production taxes and other measurements that we can take, but I do not know.

Here again, your industry is hard to follow because of the throughput and the changes. It is so variable.

Mr. Hughes, Oklahoma Natural has been affected.

Was Oklahoma Natural, prior to the order, moving a substantial amount of spot gas?

Mr. **Hughes**. Yes, sir. On an annual basis we were moving about 30 percent of our total throughput. In the nonheating season, it would probably get to 40 or 50 percent.

But let me add that our transportation has been exclusively from our system to other customers in other States. Therefore, we have not had the dilemma that these gentlemen have had in replacing their own sales with spot market transportation.

So, it has not, neither before nor after 436, has it been as onerous on the intrastates as it has potentially to be on the interstate pipelines.

Senator **Nickles**. Mr. DeLoach, you are in the gas marketing business where you would actually be involved with trying to match the producer with the end user?

Mr. **DeLoach**. Well, no; it has not ceased to exist. We have probably lost 20 percent of our total sales. Many of our sales were grandfathered under the order.

Senator **Nickles**. Primarily 311 sales?

Mr. **DeLoach**. Right; primarily 311. So, those were grandfathered and we continue to make those sales, but it hurt different marketers different ways, depending on what position they were in in the industry.

We initially got into the marketing business because we are also a pipeline gathering company and so we needed to market our reserves and deliverability off of those pipelines.

Senator **Nickles**. I am going to do what Mr. Harbor did.

Is there anybody on the panel that favors block billing?

[No response.]

Senator **Nickles**. I am going to repeat my opposition to it and then I am going to go into transportation and see if we cannot work up something on transportation.

In the first place, Mr. Harbor, did I understand you correctly that El Paso intends to be a participating pipeline prior to, what, July 1, 1986?

Mr. **Harbor**. We have set as an in-house planning target July 1, 1986. There are a lot of things that need to take place before then.

First and foremost is an action now pending in California which would, in effect, open up the pipeline systems within California to transportation.

El Paso's system stops at the border between Arizona and California. At that point, PG&E and SoCal pick it up and carry it on into the State. Unless we can move gas into the State by means of open access, then the open access on our own system becomes very limited, certainly as far as sending market signals back and forth between the end users within California.

Senator **Nickles**. So, if you can have those California markets open to you, then you are willing to open your pipeline up?

Mr. **Harbor**. We have told our customers that if we could get our service arrangements worked out and if the California commission acts affirmatively on opening up the market, we will do it before July 1.

Senator **Nickles**. Now or December 15?

Mr. **Harbor**. Nothing happens on El Paso's system. That is of no significance. I know there is some concern. I believe it was mentioned earlier by our first witness, that the December 15 date was of concern to some of the Oklahoma producers.

Our transportation will continue beyond December 15 because it is grandfathered under the 311 Program which is unaffected by the December 15 arrangement.

Senator **Nickles**. So you will be a transporter of gas strictly under 311. You will not be an open transporter of gas?

Mr. **Harbor**. That is correct.

Senator **Nickles**. You will just be grandfathering anybody that was on prior to that decision which the FERC is now reviewing some of the existing cases under 311 on a case-by-case basis. Is that correct?

Mr. **Harbor**. That is correct.

Senator **Nickles**. Mr. Kalen, is Panhandle Eastern and Trunkline doing the same thing?

Mr. **Kalen**. Trunkline is transporting at the present time for the local distribution companies. Panhandle is not.

Panhandle has a different tariff arrangement, and in order for Panhandle to be in open access transportation, we have to have an entirely new rate structure that legally would allow that to happen.

We are still studying it, considering it and we have not made a definitive decision at this point in time, but we would not anticipate being able to make that decision by December 15.

Senator NICKLES. Is Panhandle moving some 311 gas right now?

Mr. KALEN. Yes; we are moving the gas that was grandfathered. Yes, sir; we are.

Senator NICKLES. And you expect you would continue moving that beyond December 15?

Mr. KALEN. It is my understanding that under the current regulations that that will continue until the contracts expire of their own term, I believe.

Senator NICKLES. So you would be in a situation, if you did not elect to be a participating pipeline, that you could continue under 311 until those 311 contracts expire?

Mr. KALEN. That is my understanding.

Senator NICKLES. Those 311 contracts are for a term, usually, of what duration?

Mr. KALEN. I think probably the maximum is 2 years on some and of lesser terms on some.

Senator NICKLES. So you could be in a case where you opened up your pipeline over the last couple or 3 years on a spot-market basis, I believe in your case you mentioned 29 percent. That would be gradually reduced.

In other words, the FERC's rule had the exact opposite of intended effect. Instead of having a greater and greater percentage of gas moving in spot markets through your pipeline, if it is just strictly 311 and you do not participate, then as those 311 contracts would expire, your contract gas moving would decline as a percentage with time?

Mr. KALEN. Yes; and, of course, all of the gas we were moving under our special marketing program terminated on November 1.

Senator NICKLES. Was that a substantial——

Mr. KALEN. Yes; that was a considerable amount of gas.

Senator NICKLES. Was that a good part of the 29 percent?

Mr. KALEN. Approximately 10 percent of our contract demand on our general service customers. They all nominated approximately 10 percent of their contract demand and we were moving that under our special marketing program.

Senator NICKLES. Here again, you may or may not want to say this, but do you anticipate Panhandle participating? Do you anticipate Trunkline participating?

Mr. KALEN. We have not made a decision on either system at this point in time. We are continually studying that. We really did not have very much time to study such a traumatic order as this, really.

Senator NICKLES. I understand that.

Mr. Bailey, you mentioned that Northwest is participating?

Mr. BAILEY. Northwest Pipeline is participating during the 45 days.

Senator **Nickles**. Have you made a decision what you will do if it is not revised substantially after December 15?

Mr. **Bailey**. No; there has not been a decision. They were transporting under a tariff that was agreed to in a settlement decison, but there is some question as to whether all of the provisions of that tariff would comply with order 436.

If the conclusion is that it is sufficiently out of compliance with order 436, I suspect that the decision will be not to go beyond December 14.

In Northwest Central's case, we did not elect to do it, but like the other pipelines—in fact, in our case, virtually all of our transportation was under the grandfathered type of transportation agreements.

You make a very valid point in that the effect of order 436 is to cap our transportation at existing levels when we had a very substantial growth and no reason to expect that growth would not continue and create an environment until we can reach the point of being able to cross the bridge of open transportation or a progressive decline in the level of transportation.

Senator **Nickles**. Again, the pipeline panelists or any of the panelists, would you support the initiative that I said that I was planning on making a petition before the FERC to have an extension or a continuance for 6 months?

Mr. **Bailey**. Well, let me make one suggestion in that regard. I think it is important when you have that continuance to pick a proper date.

If what you ask them to do is extend the December 14 date until April 15, I do not expect that to affect individual decisions. All it does is open up a window for the same dilemma facing the pipelines that faced the pipelines between November 1 and December 14 and the same problems exist.

If you could get them to extend the October 9 date and move that into the middle of April, then what that would allow is for the balance of the winter, new 311, 319, and 234 transportation agreements could be entered into.

They could place limited terms on those or defined terms on those and leave the same ultimate termination date in place, but it would allow what was already developing to continue to develop and it would allow people an opportunity to restructure tariffs if they elected to move in the direction of being transporters.

One observation I would make about their rule is that I think the way it is styled creates a problem, because it tends to be styled either you are or you are not a transporter and that immediately creates the black-hat/white-hat kinds of rhetoric that we have been hearing.

My sense of the industry is that there will be companies that will find that the best line of business for them to be in is the transportation business, perhaps almost totally. There will be other companies that because of their unique market situations will find that the traditional merchant function best fits them and their markets and their producers.

What the Commission ought to do is foster a rule that allows free play within that full range of possibilities and do it in a way that they say that they are not going to superimpose their judgments and their perspective at 825 North Capitol on what a market ought to look like, but leave that determination to the individual market participants through their negotiations with each other.

Senator NICKLES. An interesting comment. I appreciate your suggestion as far as the date was concerned.

Mr. Hughes, you mentioned that, in your opinion, Congress should continue to have oversight hearings, but you thought the thing was so complicated that FERC should just amend their order.

Let me suggest to you that we have been working on legislation, as you are aware, for deregulation of natural gas. I think this rule has reinvigorated our desire to do so, but let me also say that for the time constraints that are involved and the pain that is going through the customers, the producers, that our efforts have been directed primarily to trying to get FERC to amend their ruling.

Mr. HUGHES. I understand that, Senator. I think that pressure needs to be there, but I think they are the ones that have to do something. If they did not understand the problem, they are beginning to, I think.

Senator NICKLES. I hope so. So, we have directed our guns initially on block billing and we were somewhat successful in getting that at least postponed.

I would not make the assumption that block billing is necessarily dead. I hope that it is, but that does not mean that it is. So, you need to be aware of that.

I encourage your participation and statements before the Commission, which is scheduled for December 11.

That is one important segment, but right now we are focusing a lot of our attention on transportation, in trying to get past this impasse.

Mr. Kalen, do you have a comment as far as that postponement?

Mr. KALEN. Well, I agree with Mr. Bailey. The fact that the October 9 date of the order caught a lot of people that were in the process of extending contracts, and what have you, got caught in the trap there. It was unfortunate.

I kind of remember when oil was headed toward deregulation. I think there was about a 3-year period for the adjustment to all occur. We were supposed to do this in 45 days or something like that and it just is unrealistic.

I think additional time would be helpful.

Senator NICKLES. You all also mentioned some legislation that INGAA is proposing?

Mr. KALEN. Well, we believe, as INGAA does, that the Commission does have authority to help us readjust supply contracts at the same time they order us to readjust unilaterally on the LDC's part of the sales contract. We think they have that authority.

Senator NICKLES. Let me rephrase that question.

I have had a problem when I see them trying to do it on one end and I have been vocal against them granting the LDC's the right to make the abrogation, and I think the pipelines have a legitimate complaint in saying, "Wait a minute. You are abrogating on the one end; you are not doing it on the other."

So I consider that a wrong. I would also say two wrongs do not make a right.

I also would have to say that I think there is a serious question, if we go forward, or if the FERC goes forward either with block billing or the 25-percent contract demand reduction, that that is a question that I think they have exceeded their statutory responsibility.

I even questioned it when we debated it in Congress and most everybody in this panel, I believe, mentioned that they support decontrol.

Decontrol means different things to different people, but as I have pushed for decontrol—some in the past have pushed for decontrol that would abrogate every contract in the books, bringing all contracts that are below the market price to market price and all the contracts above it to market price.

I have opposed that as well because I see that as overly interfering and great violation of contract sanctity.

Would the panel support a legislative effort that would decontrol old gas prices or any gas prices that still have price constraints on them, to decontrol those contracts as those contracts expire or as those contacts are renegotiated?

Anybody opposed to that concept?

Mr. **Bailey**. I think the difficulty with any partial decontrol and, in effect, you are talking about partial decontrol——

Senator **Nickles**. No; I am not quite. I am going to get on to the rest of it in a second.

Mr. **Bailey**. But in essence, if that is all that happens is a partial decontrol and we still have a substantial part of the industry that remains controlled——

Senator **Nickles**. No.

Mr. **Bailey**. It is hard for me to see that you can have any half-a-loaf solution that really improves on what we have. I think we either have to be willing as a country to have complete decontrol, say, everyone goes back and starts with a clean sheet of paper on any contract and starts over again.

My own sense is that there will never be the political constituency that would buy that.

But unless you do that, you never have really accomplished free-market pricing in gas. I would comment, as I commented earlier, I think free-market pricing will carry with it a much more volatile market, much greater price swings than have existed under our traditional form of regulation.

I think there are legitimate public policy issues as to how much of that type of marketplace and it is a harsher marketplace that we have experienced, at least at the consumer level, how much the public policy will embrace that.

Senator **Nickles**. I appreciate your comment. On the pricing segment, as you know, there is 40-something percent of the gas market that is still being categorized as old gas and basically the way I have been advocating it is one that I think the pipelines and producers and others can come together on, which is not abrogating all those old gas prices.

But it does say as those contracts expire or as they are renegotiated, they would be subject to whatever the two parties mutually agreed to, not something that Congress arbitrarily sets.

Also included would be elimination of end-use price restraints or sales restraints, Fuel Use Act, incremental pricing.

I want to thank our panelists. I have possibly some additional questions, but I know some of our panelists are from out of town and it is the day before Thanksgiving. I appreciate your willingness to come from Kansas City or other places, Washington, DC, and others.

I will conclude with this, but with the caveat that I may ask some additional questions or other panelists will as well.

Incidentally, there are other members of this committee that have an interest that probably would be here except that it is the day before Thanksgiving. So, we will keep the record open for their questions as well.

Thank you very much to our panelists.

We have also had a request from Mr. Jack Kelsey to make a statement on behalf of the Oklahoma Farmers Union.

Mr. Kelsey.

STATEMENT OF JACK KELSEY, PRESIDENT, OKLAHOMA FARMERS UNION

Mr. Kelsey. I am Jack Kelsey, president of the Oklahoma Farmers Union, a general farm organization with headquarters at 1141 West Sheridan, Oklahoma City.

Senator Nickles, we appreciate your holding this hearing concerning a matter of great importance to the State of Oklahoma and all its citizens.

The new regulations of the natural gas pipeline companies have a direct effect on producers and consumers of natural gas, as well as the pipeline companies.

Many farmers and ranchers who are mineral owners are adversely affected by the new rules for the simple reason that most pipeline companies previously transporting natural gas for independent producers are now electing not to do so.

When the Commission permitted natural gas transporters to accept or reject business from off-system producers, all but a few chose to reject this business. While this almost universal rejection by the pipeline companies was apparently not anticipated by the Commission, its devastating effects are obvious.

The shut-in of wells is widespread. These producers are unable to make delivery to their end-use customers. The abrupt disruption of service, in addition to the hardship created for the end users, also impacts upon the general economy of communities and the State.

Oklahoma has a tremendous stake in how its oil and gas industry is regulated. The Oklahoma Corporation Commission has broad powers to protect the State interest in how oil and gas is produced and distributed. Its prime responsibilities are the prevention of waste, protection of correlative rights, and determination of the amount of legally producible gas available for sale.

The manner in which the new rules of the Federal Energy Regulatory Commission has been carried out seems to infringe upon Oklahoma's regulatory body and could impede its ability to carry out its responsibilities. To say the least, much confusion has been created concerning this matter by contradictory rules and regulations.

Farmers and ranchers have also been concerned about the slower pace of exploration in the past few years. Unless the new rules are repealed or substantially modified, they will further discourage exploration and development. The current surplus could turn into a deficit.

Surely, anyone having regulatory authority over the oil and gas industry must know the precarious financial condition of many oil and gas producers. Combine this with similar conditions in agriculture and it should be evident that illogical interference with production, transportation, and marketing can further aggravate the financial stress in both the petroleum and agricultural industries and their supporting banking institutions.

Until the new FERC rules were imposed, the principal means of survival of many Oklahoma farmers and ranchers was the income from their mineral interests.

We urgently hope the new regulations can be rescinded or modified so that all producers of natural gas may have access to the markets on an equitable basis.

Senator, we again appreciate you taking the time during the Thanksgiving holiday to hold this hearing and hear the views of those who are affected.

[The prepared statement of Mr. Kelsey follows:]

STATEMENT OF JACK KELSEY
PRESIDENT, OKLAHOMA FARMERS UNION

at
Hearing Held by Senator Don Nickles
November 27, 1985
Tulsa, Oklahoma
Addressing
New Regulations of Natural Gas Pipelines
by
Federal Energy Regulatory Commission

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Many farmers and ranchers who are mineral owners are adversely affected by the new rules for the simple reason that most pipeline companies previously transporting natural gas for independent producers are now electing not to do so.

When the Commission permitted natural gas transporters to accept or reject business from off-system producers, all but a few chose to reject this business. While this almost universal rejection by the pipeline companies was apparently not anticipated by the Commission, its devastating effects are obvious.

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We urgently hope the new regulations can be rescinded or modified so that all producers of natural gas may have access to the markets on an equitable basis.

Again we appreciate you taking the time during the Thanksgiving holiday to hold this hearing and hear the views of those so adversely affected.

Senator NICKLES. Mr. Kelsey, thank you very much. I appreciate your comments.

I think it is important that you did join us today to show that the impact is not just on producers, not just on pipelines, and not just on consumers, but is on the State of Oklahoma and royalty owners and others, that it has a tremendous impact on our State and farmers and ranchers as well.

So, we appreciate your attendance, and to all of you people that are still with us at this time, and again, because it is the day before Thanksgiving, I really do appreciate your interest.

I felt like it was important and if you just look at the schedule that we have when we go back in, to get this on the record prior to FERC's decision. We needed to have this input to complement the hearings we had in Washington, DC, prior to December 14, if we are going to be successful in an extension.

I think we have shown the need for an extension.

We will keep the record open for a couple of additional weeks for additional questions and comments.

With that, we will adjourn the hearing. Thank you very much.

[Whereupon, at 12:30 p.m., the hearing adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Committee Questions

NATURAL GAS SUPPLY ASSOCIATION

1730 Rhode Island Avenue, N.W.
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(202) 331-8900

Nicholas J. Bush
President

Mr. Howard Useem
Professional Staff Member
Energy Regulation and Conservation Subcommittee
Committee on Energy and Natural Resources
United States Senate
SH 212, Hart Senate Office Building
Washington, D.C.

Re: Follow-up questions to witnesses appearing at November 21, 1985 Subcommittee hearing before Senate Energy Regulation and Conservation Subcommittee

Dear Howard:

Please find enclosed herewith NGSA's responses to the questions propounded to us by Senator Bingaman earlier this month. If you have any questions or require additional information, please do not hesitate to contact me at your convenience.

Thank you for your cooperation and assistance.

Sincerely,

Nicholas J. Bush
President

Enclosures

NJB:WJS:jt

Representing the Nation's Producers of Natural Gas

RESPONSE TO QUESTIONS PROPOUNDED BY SENATOR BINGAMAN
TO
MR. DAVID A. HENTSCHEL
TESTIFYING ON BEHALF OF THE
NATURAL GAS SUPPLY ASSOCIATION (NGSA)
BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

(HEARING DATE: NOVEMBER 21, 1985; RESPONSE DATE: JANUARY 24, 1986)

QUESTION 1:

"By now, I realized all of you have reviewed the Secretary of Energy's proposal to raise natural gas prices and to increase production of regulated old gas. I would like to know your initial impressions of the Secretary's proposal. Do you think FERC should implement the proposal?"

RESPONSE:

Insofar as this question pertains to NGSA's position with regard to the Federal Energy Regulatory Commission's (FERC) "Notice of Procedural Schedule" (NOPS) (Docket No. 86-3-000), issued December 20, 1985, NGSA does not intend by this or the following response to supplant or amend its comments concerning this issue, to be filed before the Commission on February 25, 1986.

Initial review of the Secretary's proposal to eliminate vintaging for old gas prices indicates that the proposal is generally consistent with NGSA prior positions on this issue. Therefore, NGSA generally supports the concept contained in the

Department of Energy's (DOE) proposal, but with qualifications. As may be expected in any rulemaking so broad in scope and dealing with issues as complex as those addressed by the Secretary's proposal, revision may be necessary.

NGSA's analysis of the DOE proposal concerning the elimination of vintaging for old gas is presently in progress. Among the possible problems with the proposal revealed during the initial review stage are contract abrogation issues. However, NGSA is confident that with appropriate refinement the DOE proposal can and should be adopted by the FERC.

QUESTION 2:

"With the reissuance of the block billing proposal, how do you see the new proposal affecting our development and exploration efforts for natural gas. I asked this same question at our September hearing and there was general consensus that we would see a 30% cut in natural gas production. Do you think that percentage will change with the reissued proposal? What impact do you think it will have?"

RESPONSE:

Although I have not had an opportunity to review the transcript of the September 19th proceedings before the Subcommittee, it is my recollection that the discussion during which the 30% reduction in drilling level figure surfaced, concerned the probable impact of the original block billing proposal upon exploration activities. At the outset, a distinction must be made between the level of "development and exploration efforts" and the level of "natural gas production" which you refer to in your question. The distinction to be made is important because it concerns the time when the differing consequences of the block billing proposal will be felt throughout the economy.

If implemented as proposed, the block billing proposal would have a relatively immediate effect upon the level of what you have referred to as "development and exploration efforts for natural gas." Past exploration and development activities for natural gas have yielded a current deliverability surplus. However, the continuing precipitous drop in the level of such exploration and drilling activities will inevitably cause future production to decline dramatically.

NGSA believes that FERC and Congress have asserted in the past that a primary concern is to assure that adequate domestic supplies of natural gas are continually developed and maintained. With the issuance of the revised NOPR, FERC continues to divert its attention and focus solely on consumer prices at the expense of continuity in future domestic gas supplies. As I discuss below in greater detail, any drop in the level of producer revenues will be translated immediately into decreases in producer exploration and drilling budgets. Reduced levels of exploration and drilling invariably result in lower reserve levels and, ultimately, higher natural gas prices to consumers.

As I stated in my written testimony before the Subcommittee, commencing at page 6, block billing as revised by the Commission would retain below market prices for a substantial portion of the nation's proved natural gas reserves and would maintain prices for these supplies below the costs of replacing the gas.

The Energy Information Administration (EIA) estimates of 1984 preliminary natural gas reserves demonstrate the continuation of an alarming trend which will certainly be exacerbated by FERC's block billing proposal. EIA figures indicate that natural gas production once again outpaced the level of new gas discoveries in 1984. New gas discoveries in 1984 amounted to only 79% of the level of natural gas production.

Substantial gas price reductions are already occurring at the supply end to bring short-term supply and demand in balance under current policies. The block billing proposal will not smooth this transition nor will it eliminate the distortions and inequities which make the transition difficult. Block billing will have severe consequences for long-term supply and demand balance by encouraging excessive demand for price controlled gas while not eliciting any additional old gas supplies.

In fact, because block billing will reduce prices for gas supplies, the level of capital available to producers to fund the exploration and development of gas supplies will drop substantially. Foster Associates, Inc., has estimated the potential loss of revenue due to block billing at between 5.3 billion and 17.1 billion dollars over the years 1986 through 1990. The subsequent reduced levels of drilling could cause future reserve additions during those years to be 1.8 to 5.8 TCF lower than they otherwise would have been. With proven reserves of natural gas at their lowest level since 1976 -- the year of curtailments and shortages -- it is remarkable that FERC is considering a proposal which might exacerbate the current slump in exploration and drilling activity.

The statistics concerning levels of drilling activity are alarming. During the peak year in 1982, the producing industry spent $19.7 billion to drill 24,695 successful gas wells and dry holes. Those wells replaced 83% of that year's production with new discoveries -- still a net loss in reserve levels. Drilling expenditures in 1984, however, dropped precipitously to $10.0 billion -- a 49%

decrease. This reduction in drilling expenditures caused the number of wells drilled to decrease by 8% to 22,680*/.

In 1981, which was a very good year for the drilling business, the rotary rig count averaged 3,970. By January 6, 1986 the rig count stood at 1,915 -- a 52% reduction since 1981 in the number of rigs working in this country. The number of active rigs in the United States today is 19% lower than it was in November, 1978, when the Natural Gas Policy Act was passed with the purpose of encouraging a substantial increase in the level of domestic energy exploration activities.

The figures for 1985 are still being compiled. Preliminary indications are that the slump in exploration and drilling activity has deepened. Predictions for 1986 are for continued depressed levels of natural gas exploration and drilling.

If block billing is implemented, the range of the resulting Block II prices would yield substantially fewer gas wells drilled per year. According to figures prepared by the Petroleum Equipment Suppliers Association, the impact on employment would be staggering. From a high in 1982 when employment stood at 600,000 jobs in drilling industries, employment now stands at less than 250,000 -- a loss of 350,000 jobs. Implementation of block billing undoubtedly would cause a large number of the remaining jobs to be eliminated with a strong ripple effect upon associated businesses.

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*/ Because of the decline in oil and gas exploration and development, oil drilling service companies have substantially reduced their charges for drilling services, thereby resulting in a well drilling decrease which is less than the expenditure decrease. However, these firms are in an acute state of financial distress and would face bankruptcy if their drilling charges further declined. Therefore, future reductions in exploration and development expenditures are likely to result in a reduction in well drilling of an equal proportion.

In the remainder of my written testimony presented to the Subcommittee during the hearing on November 21, 1985, I discussed in relative detail the other potential impacts likely to result from implementation of the revised block billing proposal. Rather than repeat those points here, I refer you to pages 9 through 20 of my testimony (attached) for further details.

EXXON COMPANY, U.S.A.
POST OFFICE BOX 2180 • HOUSTON, TEXAS 77252-2180

C. M. HARRISON
SENIOR VICE PRESIDENT

January 23, 1986

The Honorable Don Nickles
United States Senate
713 Hart Senate Office Building
Washington, DC 20510

Dear Senator Nickles:

We appreciate the opportunity to respond to the questions posed by Senator Bingaman in your correspondence of January 2, 1986, concerning (1) our initial impression of the Secretary of Energy's proposal to raise old gas prices and (2) the supply impact of block billing. As you recall, I testified that Exxon supports raising old gas prices to market levels and strongly opposes block billing, primarily because of the adverse effect it would have on U.S. gas supplies.

The best way to remove any distortions and inequities and to allow the market to balance supply and demand is to decontrol the wellhead price of gas. Absent decontrol legislation, the FERC should exercise its authority by establishing a market-defined "just and reasonable" price for old gas. It is clear by the FERC's own definition of a just and reasonable price that the current regulated prices for old gas are not just and reasonable because (1) they do not "bring about\efficiency in both production and consumption of natural gas"; (2) they do not "permit 'fair' competition"; (3) they do "lead to the wasteful depletion of scarce, non-renewable resources" and (4) they are "not appropriate to changing conditions in the natural gas industry."

In response to the first question, we believe that the Secretary of Energy's proposal for FERC to raise old gas ceiling prices, eliminate vintaging and establish incentive ceiling prices for certain categories of old gas is aimed in the right direction. However, we are still reviewing the negotiating mechanism proposed for collecting higher prices under existing contracts and may recommend modifications.

One disturbing aspect of the Secretary's proposal is that it seems to invite linking action on old gas prices to action on block billing. FERC, in fact, has requested comments on whether the two can be adopted concurrently. Raising old gas prices to market levels eliminates the pricing problems that block billing fails to solve. We believe that block billing would be illegal, would adversely impact gas supplies and would create additional market distortions and inequities. We strongly recommend that block billing not be implemented and that, in its place, old gas prices should be permitted to rise to market levels.

In response to the second question, our analysis supports the general industry consensus that producer revenues would be reduced by $3-6 billion per year as a result of block billing. A reduction in revenues of this magnitude would be equivalent to around 30-60% of total drilling expenditures in 1984. This loss in revenue would be devastating to the producing sector. Gas producers would be forced to cut back exploration and development activity beyond even current depressed levels.

We estimate that one to two TCF fewer reserves would be found during the first year following block billing. To put this into perspective, the latest DOE historical data indicate that industry added 14.4 TCF of gas reserves in 1984, an amount equal to only 80% of 1984 gas production. Although we have not sought to estimate the reserve impact beyond one year, the cumulative longer term impact would likely be large.

Very truly yours,

CM. Harris

CMH:aln

Mobil Oil Corporation

150 EAST 42ND STREET
NEW YORK, NEW YORK 10017

H.K. HOLLAND, JR.
VICE PRESIDENT PRODUCING
EXPLORATION AND PRODUCING DIVISION

January 23, 1986

Honorable Don Nickles
Chairman
Subcommittee on Energy Regulation
and Conservation
United States Senate
Washington, D.C. 20510

Dear Senator Nickles:

Mobil Oil Corporation is pleased to respond to the two questions posed by Senator Bingaman pertaining to Mobil's position on the Department of Energy's (DOE) proposal to raise old gas prices and the projected impact of FERC's block billing proposal on Mobil's future domestic exploration and producing budget. Mobil has long been a supporter of legislative and regulatory initiatives which reduce federal regulation, reflect a free market commodity-type approach to the production and marketing of gas in the United States, and preserve contract sanctity.

Mobil has reviewed DOE's proposal to raise old gas prices and our initial impression is the proposal has many positive features which Mobil can support, particularly the concept of raising the price of all old gas vintages up to a single "just and reasonable" ceiling rate. Mobil believes if such action were taken, the domestic gas market would function much more efficiently, valuable old gas reserves would not be prematurely abandoned, and the overall price of gas to consumers in the long-run would be lower than under the present systems of regulation. Mobil plans to submit more detailed comments on this proposal to FERC after we have completed our analysis.

Regarding the second question posed by Senator Bingaman, Mobil has been strongly opposed to block billing since it was first proposed by the Commission on May 30 in the Notice of Proposed Rulemaking in Docket No. RM85-1 for each of the following reasons: (1) block billing violates the statutory requirements of both the Natural Gas Act and Natural Gas Policy Act and if enacted in the modified form proposed by FERC on October 9, will be subject to legal challenge; (2) block billing will create a whole new dimension of uncertainty in domestic gas markets at a time when gas producers and consumers desperately need a more stable and predictable business environment to meet the strong challenge of alternative fuels; (3) block billing will create major disincentives for new gas drilling by producers at a time when the nation's reserve base is being substantially eroded; and (4) block billing totally fails to address the fundamental underlying cause of current market distortions, old gas price controls, and instead establishes a new type of complicated federal entitlements systems which is unduly discriminatory and patently inequitable to certain classes of customers and regions of the country.

In its public notice on October 9, 1985, the FERC cited concern over the gas supply implications of block billing as the primary reason for delaying implementation of block billing. Whereas, under rolled-in pricing, pipeline sales customers see only a single price (the weighted average cost of gas), block billing may allow them not only to distinguish between two component parts of the gas stream, but selectively to elect to purchase only the below-market priced, i.e., the Block 1 component. Such a regulatory approach is certain to chill future exploration efforts and ultimately lead to gas shortages and higher prices for consumers. Mobil has not attempted an estimate of the production drop referred to as 30%, but we do not see any significant change to the percentage resulting from the reissued proposal.

Mobil is convinced, as we believe you are, Congress can only ensure consumers of sufficient gas supplies at the lowest price by deregulating all natural gas and thereby permit all natural gas to be sold in the market place as a fungible commodity. We urge you to continue your legislative efforts to decontrol all gas and stand ready to assist you in accomplishing this vital goal.

Sincerely,

H. K. Holland, Jr.

Shell Oil Company

One Shell Plaza
P.O. Box 2463
Houston, Texas 77001

January 22, 1986

Senator Don Nickles
Chairman
Subcommittee on Energy Regulation
and Conservation
358 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Nickles:

In reply to your letter of January 2, 1986, I am enclosing for the record my responses to two questions raised by Senator Bingaman. These reponses will supplement my testimony on November 21, 1985, before the Subcommittee on Energy Regulation and Conservation.

Thank you for the opportunity to testify before your subcommittee. I hope that the oversight hearings have demonstrated that continued federal regulation of natural gas is not the answer to the nation's energy needs.

I am also sending a copy of my responses directly to Senator Bingaman.

Yours very truly,

R F Nelson

R. F. Nelson
General Manager
Natural Gas

RAL:RMT

Enclosure

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RESPONSES TO QUESTIONS
FROM SENATOR BINGAMAN

I

Question

By now, I realized all of you have reviewed the Secretary of Energy's proposal to raise natural gas prices and to increase production of regulated old gas. I would like to know your initial impressions of the Secretary's proposal. Do you think FERC should implement the proposal?

Answer

Shell is in favor of the Secretary of Energy's proposal to increase "old" gas prices to just and reasonable levels. As might be expected, we have found a few flaws in the proposal, but Shell applauds the direction toward market prices for all gas.

In my testimony which was submitted for the hearing on November 21, 1985, I addressed the question of just and reasonable pricing for old gas. Beginning on page 10 of the testimony, I pointed out the need for and the benefits of such pricing. For convenience, I am attaching a copy of that testimony. However, in the interests of brevity and to prevent duplication in the record, I ask that it not be repeated in the record.

Now that the Secretary of Energy has presented a specific proposal to the FERC for its consideration, I can only repeat the conclusion reached in my testimony -- that just and reasonable pricing, while far from a substitute for gas decontrol, will provide substantial benefits to the nation.

II

Question

With the reissuance of the block billing proposal, how do you see the new proposal affecting our development and exploration efforts for natural gas. I asked this same question at our September hearing and there was general concensus that we would see a 30% cut in natural gas production. Do you think that percentage will change with the reissued proposal? What impact do you think it will have?

Answer

I refer to pages 7 through 9 of my written testimony for Shell's position on the FERC's clarified and reissued block billing proposal.

While not favoring block billing, Shell does not subscribe to the position that its adoption would result in any particular outcome. As proposed, block billing produces many uncertainties which could produce a wide range of possible results, ranging from no changes to a major negative supply impact. These uncertainties include: (1) the rate structures devised by some 48 state regulatory authorities, (2) the presence or absence of competition for each pipeline, and (3) the prices of alternate fuels in each market area.

Although Shell does not necessarily see any specific result from block billing, it does not see any positive benefits; if there is any great effect, it would have a negative impact on domestic gas supplies.

In view of the near-unanimous opposition to the reissued proposal, the FERC would be well advised to allow block billing to fade away.

BKAI861502

STATEMENT OF RICHARD F. NELSON
GENERAL MANAGER - NATURAL GAS
SHELL OIL COMPANY
BEFORE THE SUBCOMMITTEE ON
ENERGY REGULATION AND CONSERVATION
OF THE SENATE ENERGY COMMITTEE
NOVEMBER 21, 1985

My name is Richard F. Nelson. I am General Manager of Natural Gas for Shell Oil Company (Shell), and I am responsible for the marketing of natural gas by Shell and its affiliated companies in the United States.

I am pleased to share with you Shell's position on the Federal Energy Regulatory Commission (Commission) Order No. 436, issued October 9, 1985, at Docket No. RM85-1-000.

I

Shell's reaction to the Final Rule

Basically, Shell believes that the Commission has adopted a framework that, for the first time, would introduce meaningful competition into the gas industry. Some of the elements of the Final Rule which Shell supports include:

- Allowing transportation without regard for the category of gas, the source of gas, the identity of the shipper or the end use of the gas,

- Setting volumetric transportation rates to optimize use of the interstate pipeline systems,
- Unbundling transportation rates from rates for other services such as storage,
- Allowing negotiated rates to encourage competition between pipelines for transportation business,
- Recognizing that managements of pipelines and distributors should bear risks and obtain rewards for their decisions,
- Favoring negotiations between pipelines and producers to resolve contractual take-or-pay problems, without setting strict guidelines for their negotiations,
- Adopting a policy in favor of expeditious abandonment of gas which is not being taken by pipelines, and
- Establishing an alternate certificate procedure to further facilitate competition for both transportation and sales of gas.

Although Shell applauds most of the provisions of the Final Rule, it has, in the process of applying for rehearing of Order No. 436, pointed out some inequities in the Order. The most serious of these flaws is the granting to firm pipeline customers the dual authority to reduce firm contract demand of up to 25% per year (an abrogation of executed service agreements) and to convert the volume so reduced to firm, preferred transportation rights (an undue preference contrary to the principle of non-discrimination).

Perhaps as important as what the Commission did in the Final Rule is what it refused to do. On the positive side, the Commission declined to follow suggestions that it authorize pipelines to cancel contracts with producers and that it condition producer access to transportation only upon waiving contract rights such as take-or-pay. Had the Commission attempted either action, Shell is confident that the Commission would have been reversed in an appellate court.

On the other hand, while the defect was not apparent at the time Order No. 436 was issued, it now appears - a month and a half after that date - that the Commission was too quick to terminate existing transportation programs. Because of the reaction of pipelines to transportation under the Final Rule, which is discussed below, the Commission should have provided for a reasonable transitional period.

Pipeline reaction to the Final Rule

At least initially, the interstate pipelines have almost universally rejected the Commission's invitation to become competitive. Despite the pipelines' public stance that voluntary transportation is working and that mandatory carriage is not needed, when the Commission asked them to provide transportation service on a non-discriminatory basis, the pipelines refused.

One by one, pipelines have notified Shell that they will not become transporters under Order No. 436. The reasons given vary from company to company: they are still studying the Order; they are afraid of losing markets; they need clarifications; they didn't get what they asked for from the Commission; and so on.

Alibis aside, it is becoming clear that the interstate pipelines are quite content with their present position. They are able to exert near-monopsonistic power as purchasers and near-monopolistic powers as resellers. The pipelines have - and want to keep - absolute control over transportation access. Competition is a foreign concept to the pipelines, and they like it that way.

Yet, while the pipelines refuse to participate in the competitive arena, they also refuse to accept their role as gas merchants, responsible for buying from producers and providing secure service to distributors and users. In other words, the pipelines are refusing to live up to the contracts they signed. And we have seen no efforts by the pipelines to take advantage of the alternatives given them by the Commission in the Final Rule. These include the invitations to buy out or buy down their take-or-pay "problem" contracts and to offer producers release and abandonment of unneeded gas.

In the face of a united front by the pipelines, Shell has no choice but to insist on punctilious performance by pipelines under contracts. Shell takes this position with reluctance; it would much prefer to compete under the Commission's transportation program and to renegotiate contracts rather than litigate to enforce contracts. However, if the opportunity to have gas transported is denied Shell because of pipeline intransigence, Shell will not permit them to have the best of all worlds, with Shell and other producers bearing all market risks and guaranteeing pipeline profit margins.

Shell is also deeply concerned about the anticompetitive unanimity of the pipelines. We find it curious that not a single pipeline management has seen fit to file for a long-term blanket transportation certificate, to try take-or-pay buy-downs or to offer to help producers abandon sales.

The Commission versus the pipelines

In the face of virtually total rejection of Order No. 436 transportation, the Commission has adopted an equally hard line in defense of its Order.

Since October 9, when the Final Rule was issued, the Commission has put out a series of technical corrections and clarifications. In almost all cases, those orders narrowed the scope of lawful transportation which could be performed outside of the Final Rule after November 1. In addition, the Commission chose not to grant the requests of producers and marketers for short-term blanket transportation of higher-priced gas released from contracts for sale at market prices. Instead, it granted only the authority for limited-term abandonment and sales for resale, without giving any rights for essential transportation. In this case, half a loaf is not even a crumb.

We now have an impasse; pipelines will not play in the new game, and the Commission will not relax the rules. This test of wills would be interesting to watch except that the real losers in this contest are the producers denied access to markets and the consumers denied competitively-priced gas.

II

The Block Billing proposal

Order No. 436 did not issue the controversial - and much misunderstood - Block Billing proposal. Instead, the Commission clarified its earlier proposal and asked for additional comments on the revised billing procedure.

Shell is pleased that the Commission has clarified that Block Billing is literally that - a method of splitting customers' bills into two blocks. This is merely an after-the-fact notification of the relative volumes delivered from each block during the preceding month. It is now clear that a customer cannot designate volumes of gas to be delivered from a block and that a pipeline cannot call on producers to deliver gas preferentially from a block. Furthermore, the Block Billing proposal does not override state authority, either conservation and proration rules in producing states or the pricing jurisdiction of agencies in consuming states. And most importantly, the Commission has declared that Block Billing in no way authorizes pipelines to breach contracts with producers.

Thus, Block Billing is not a panacea for distributors, an escape hatch for pipelines, a disaster for industrial users or a road to ruin for producers.

Shell's position on Block Billing

Although Shell does not oppose Block Billing with the fervor seen in public statements by some producers, Shell certainly does not support it.

Essentially, Shell agrees with the Commission that there are serious flaws in the present billing system and there are inefficiencies and distortions in rolling in prices for controlled and decontrolled gas. Shell further agrees with the Commission's principles that proper pricing should promote efficiency in both production and consumption, should permit fair competition, should discourage waste and should accommodate changes in market conditions.

However, Shell unequivocally states that Block Billing will neither solve existing problems nor achieve the Commission's goals.

As long as there exists a system in which gas is half slave and half free, the basic distortions will continue. Historic customers will continue to have an advantage over new customers; users in regions endowed by historic accident with large supplies of old gas will have an edge over their competitors in less favored parts of the country served by pipelines with higher-priced gas; mixed, conflicting price signals will be sent to producers, continuing the tragic boom/bust cycles of supplies; and some 48 state regulatory agencies will still have the final say over how gas will be priced at the burnertip. These conditions will exist with or without Block Billing; the only change effected by Block Billing would be to rearrange the current advantages and disadvantages among consumers, distributors, pipelines and producers.

Block Billing has been touted by some observers (but not by the Commission) as a mechanism for the transfer of wealth from producers to consumers. Nothing could be farther from fact. Actually, as long as average wellhead prices are at market clearing levels, consumers, on average, will see no substantial changes in prices, and the producing industry's revenue will be substantially the same.

The distribution of wealth under a Block Billing scheme, if one is to occur, will be among produters. Accordingly, there is no appreciable reason for the Commission to referee an intramural scuffle. The powerful forces of the marketplace - stronger than artificial billing rules - will control who wins and who loses. The power of market forces was recently demonstrated when the predicted "fly-up" became a "fly-down" on January 1, 1985.

III

The alternative to Block Billing

The Commission does have authority to cure the present ills in the industry and to reach its pricing objectives: it can increase old gas prices to just and reasonable levels. That authority was expressly given to the Commission in the Natural Gas Policy Act of 1978 (NGPA) as to gas covered by sections 104 (old interstate gas), 106 (rollover contracts) and 109 (other gas) of that statute.

If the distorting effects of permanently-regulated gas are removed from the market picture - rather than being hidden under a State regulatory agency's agenda - subsidies of one group for another will in turn disappear. Price parity will be available to all regions and all consumers; market pressures will cause too-high prices to come down; and correct signals will be exchanged between producers and consumers. In short, a free, unfettered and efficient gas market will develop.

Benefits of just and reasonable pricing

Not only will the gas market become rational if just and reasonable pricing is instituted, but the national interest will be enhanced by the production of gas from old fields which could not be economically recovered under unrealistic regulated ceiling prices.

Two years ago, Shell presented testimony to this Subcommittee. At that time, we introduced a study by Dr. C. S. Matthews, a Senior Petroleum Engineering Consultant for Shell, which indicated that approximately 52 trillion cubic feet of additional gas could be produced over time as a result of total gas decontrol. The rationale and methodology of that study has been accepted in principle by others, including the Office of Technology Assessment. While the numeric conclusions have differed from reviewer to reviewer, it is now widely accepted that old gas is responsive to price increases and that the response is significant.

Last September, Shell again testified before this Subcommittee. In connection with that appearance, we presented a similar study by Dr. Matthews to estimate how much old gas reserves would increase if S. 1302, a gradual decontrol bill, were enacted. The new study is attached as Appendix A.

I must point out that there is not equality between absolute deregulation and just and reasonable rates set by the Commission. Free market pricing has no floor and no ceiling; a just and reasonable rate is, in the words of the statute, a maximum lawful price. In addition, we would expect that an agency-set price would be fairly inflexible and probably tending to the low edge of reasonableness - if past Commission decisions are a guide. There is no real administrative substitute for true deregulation.

However, Dr. Matthews' study is cited to demonstrate the magnitude of additional reserves which could become available if the Commission were to exercise its authority to set just and reasonable rates which approximate commodity values.

Description of the reserves study

At an average market clearing price for gas over the next decade of $3.00 per MMBtu (in 1985 dollars), the study indicates that enactment of S. 1302 or comparable legislation would add between 31 and 37 trillion cubic feet to U.S. gas reserves. This is about two years' U.S. gas production. These reserves would be added in three ways. First, an increase in gas prices upon contract expiry would enable the lowering of abandonment pressure in old gas fields. At a higher gas price, the wells in those fields can be produced to a lower producing rate before revenue is equal to producing costs. Thus, the fields will reach lower abandonment pressures, which will result in additional gas' being recovered.

The second method by which reserves will be added by deregulation is due to additional well stimulation. Fracturing and acidizing of old wells opens new pay zones and enhances the contribution of zones of low productivity. At low, regulated gas prices, this stimulation is usually uneconomic and will not be carried out. However, as contracts expire and the prices for gas rise, many well stimulation treatments become profitable and will be undertaken.

We estimate that the combined effect of lowering of abandonment pressure and additional well stimulation due to deregulation on contract expiry could add from 20 to 26 trillion cubic feet to U.S. gas reserves at an average $3.00 per MMBtu market price.

The price currently allowed by the NGPA for new, onshore production wells ($3.05 per MMBtu) is about the same as our assumed average market clearing price over the next decade ($3.00). Thus, enactment of deregulation legislation will cause little or no additional development and infill drilling in old gas fields at this time. We should keep in mind, however, that the $3.05 NGPA price is frozen forever in real terms. Gradual deregulation will lead to additional infill drilling when gas prices rise above the $3.05 per MMBtu price (in 1985 dollars). Our $3.00 per MMBtu average price for the next decade assumes a price somewhat less than $3.00 for the initial five years and a somewhat greater price for the last five years. Thus, there would be a positive effect on infill drilling in the 1990's.

We have estimated in Appendix A that the potential reserves due to infill drilling at prices above $3.05 per MMBtu (in 1985 dollars) will be about 11 trillion cubic feet.

Thus, the total additional reserve additions due to enactment of a statute such as S. 1302 will range from 31 to 37 trillion cubic feet.

The 31 to 37 trillion cubic feet of gas to be recovered by freeing old gas from unrealistic pricing controls simply must be produced. If that gas is not produced, this invaluable domestic resource will be completely wasted - a tragedy to the national interest.

The economic benefits from just and reasonable pricing due to these additional recoveries of old gas reserves are documented in Appendix B. Those benefits are:

- The U. S. balance of trade would be improved by $50.5 billion (in 1984 dollars) over the next ten years due to reduced volumes of imports of alternate fuels.
- Non-switchable gas consumers would save $25.3 billion (in 1984 dollars) over the next twenty years by fully using existing transportation and distribution systems.
- Government revenues, both federal and state, would be enhanced by taxes and royalties on increased domestic production.
- More U. S. employment opportunities would be provided.

The anticipated knee-jerk reaction to increasing old gas prices is the old saw that consumer prices will go up. It may surprise you, but the contrary is true: average consumer payments for gas would not rise. The basic reasons for this are that average gas prices today are at market-clearing levels and that the old gas fields are already connected to the nation's pipeline system, with no new facilities being necessary to bring this over-30 trillion feet of additional gas to market.

BKAI8530502

Congress has repeatedly shown its concern for America's energy future. It has encouraged conservation of energy resources in enacting laws regarding such things as home insulation and gasoline mileage. Congress cannot sit idly by while an enormous volume of potentially producible gas is left in the ground due to administrative inaction. If the Commission again refuses to exercise its prerogatives to let old gas be produced, Congress must act.

Gas surpluses and shortages

Let us not be deluded by today's "bubble" of surplus gas deliverability. The gas from those old fields will be needed! Frankly, the NGPA has not worked to elicit necessary gas reserves. Despite claims of future abundance, one fact cannot be denied: there are less lower-48 gas reserves today than when the NGPA was enacted. And the situation is getting worse. All we have to do is observe today's moribund drilling rates to see that 1985 reserve additions will not replace current production - which has not even occurred during years of heavy drilling activity.

The bubble will burst, and the cycle of shortage and surplus, each caused by shifts in federal regulatory policy, will continue.

Conclusion

I cannot simply come here and testify about the Commission's Order No. 436 and talk about regulatory alternatives.

I must remind this Subcommittee that there is but one final solution to this nation's recurring natural gas problems: full, complete and total deregulation of all gas as soon as possible.

APPENDIX A

Increase in U.S. "Old Gas" Reserves
Due to Enactment of S. 1302

The treatment here follows that given in the April 1983 study entitled "Increase in United States 'Old Gas' Reserves Due to Deregulation," by C. S. Matthews, Shell Oil Company. That study was submitted in April 1983 to the U.S. House of Representatives Subcommittee on Fossil and Synthetic Fuels of the Committee on Energy and Commerce.

In the April 1983 report, we estimated that reserves of old gas in the lower 48 states which would respond to deregulation were about 115 Tcf as of January 1, 1981. At that time we included 30.8 Tcf of intrastate gas in the 115 Tcf. We did this because, even after the so-called deregulation of much of intrastate gas on January 1, 1985, an additional price limit was placed on this deregulated gas. In our April 1983 study this price limit was less than our assumed market clearing price. Thus, this gas was really not price deregulated under those market conditions.

Under current market conditions, we find that the price limit placed on this deregulated intrastate gas is greater than the current market clearing price. Thus, we should subtract from 115 Tcf, the reserves of intrastate gas which were deregulated on January 1, 1985. We estimate that about 73 percent of intrastate gas was deregulated at that time. Therefore, we subtract .73 (30.8) = 22.5 Tcf from 115 Tcf and obtain 92.5 Tcf as the base responsive to decontrol.

The calculations shown in Table 1 of the cited report are now repeated for a deregulated price over the next decade of $3.00 per MMBtu. This leads to an increase in reserves due to lower abandonment pressure for the 14 fields in Table 1 of 9 Tcf. We scale this up to the total U.S. by multiplying by 92.5/41.3 where 41.3 is the reserve for the 14 fields and 92.5 is the total responsive reserve base of old gas in the United States as of January 1, 1981. This gives 20 Tcf as the estimated increase in old gas reserves due to lower abandonment pressure at the $3.00 per MMBtu price.

We estimate the increase in reserves due to fracturing and acidizing as 1.5 percent of ultimate as discussed on page 18 of the cited report. For the response base of 92.5 Tcf, the ultimate is 92.5 (475)/115 = 382 Tcf. Thus, the fracturing and acidizing increase is 0.015 (382) = 6 Tcf.

The total possible response is 20 + .6 = 26 Tcf.

In applying these calculations to S. 1302, we estimate that about 10 percent of old gas contracts with expiry dates will expire each year. S. 1302 also contemplates relief for those contracts which will not expire soon enough to achieve deregulated price relief -- even those contracts having a term for the life of the lease or the reserves. Proposed section (f)(2) would allow the parties to renegotiate contracts to bilaterally increase price to levels sufficient to continue economic production. Thus, within the next decade nearly all old gas contracts will expire or can be renegotiated to continue economic production. In this time frame, we estimate that no significant number of fields will be abandoned. Although some wells in a field may be abandoned, the remainder still producing at contract expiry can be produced to the new lower reservoir abandonment pressure and thereby increase gas recovery from these fields. The maximum increase for the U.S. is estimated above to be 20 Tcf.

Fracturing and acidizing would also be undertaken on contract expiry. In addition to enhancing productivity of old wells, this in many cases would open new pay zones and increase production from low productivity layers. This would lead to the estimated 1.5 percent increase in ultimate production from the wells (6 Tcf). As some wells will be abandoned before contract expiry, the 6 Tcf should be viewed as a maximum.

In summary, we estimate that the combined effect of lowering of abandonment pressure and additional well stimulation due to enactment of S. 1302 will increase U.S. "old gas" reserves by 20 to 26 Tcf.

Thus far we have not have not addressed infill drilling. Enactment of S. 1302 would not lead to additional infill drilling at this time. This is because the current price allowed by the NGPA for regulated onshore infill wells ($3.02 per MMBtu) is about the same as our assumed market clearing price over the next decade ($3.00 per MMBtu in 1985 dollars). However, we must keep in mind that the NGPA price of $3.02 is frozen forever in real terms. It rises only with inflation. Thus, enactment of S. 1302 would have a positive effect on infill drilling when gas prices rise above $3.02 per MMBtu (in 1985 dollars). Our $3.00 per MMBtu average price for the next decade assumes a price somewhat less than $3.00 for the initial five years and somewhat greater for the last five years. Thus, S. 1302 would have a positive effect on infill drilling in the 1990's.

To estimate how much such infilling would add to "old gas" reserves, we refer to the section on infill drilling in our cited April 1983 report. Because additional infill drilling would not occur for some time, we eliminated fields where the gas reserve was less than 20 percent of ultimate recovery in 1981. This eliminated Puckett, Carthage, Kettleman Hills and Rio Vista. We also eliminated the high-cost infill fields, Bayou Sale, Bastian Bay, Katy and Old Ocean reasoning that infilling would only occur well into the future. By so doing we eliminate 18 percent of the infill potential of the Analog Fields in Table 1.

Our previously-calculated infill reserve addition for the total U.S. was 18 Tcf, using a response base of 115 Tcf. For our revised response base of 92.5 Tcf, the potential U.S. reserve additions are 14.5 Tcf. If we assume for reasons stated above that we will obtain only 82 percent of this potential, our estimate becomes 12 Tcf.

Of this 12 Tcf potential, infill wells not drilled on acreage committed or dedicated to interstate commerce on April 20, 1977 where either decontrolled on January 1, 1985 or will be decontrolled on July 1, 1987. We can estimate the magnitude of this from information in Table 12 of "U.S. Crude Oil and Natural Gas Reserves," 1977 Annual Report by the U.S.

Department of Energy. That Table indicates that about 5 percent of gas reserves in the lower 48 states were not committed as of December 31, 1977. Thus, 5 percent should be subtracted from the 12 Tcf potential due to decontrol in the above-mentioned categories. This brings our final estimate to 11 Tcf due to additional infilling brought about by S. 1302.

Thus, the total potential reserve additions due to the enactment of S. 1302 are 31 to 37 Tcf.

APPENDIX B

ECONOMIC BENEFITS FROM "JUST AND REASONABLE" PRICES FOR ADDITIONAL RECOVERY OF OLD GAS RESERVES

CONCLUSIONS

- Improves U.S. balance of trade by $50.5 billion (1984 dollars) over the next 10 years due to reduced volumes of alternate fuel imports.
- Non switchable gas consumers would save $25.3 billion (1984 dollars) by fully utilizing the existing transportation and distribution systems over the next 20 years.
- Provides opportunities for higher government revenues in the form of royalties and taxes.
- Provides domestic employment opportunities.

Discussion

The initial assumption in this analysis is that the additional gas recovery documented in C. S. Matthews' study* is assumed to come gradually to market. The loss of these gas reserves will require substitution by alternate fuels. The current alternatives to domestic natural gas are imported fuels or domestic coal. The following analysis compares the cost of imported fuels as they are substituted for old gas production which is abandoned due to uneconomic gas prices. While it was assumed that the 31-37 TCF additional reserves estimated by the Matthews' study would translate into available production over a 20-year period, we have based our primary calculations of imported fuel substitution on a conservative 10-year period. Beginning in the mid-1990's domestic coal could be an alternative to domestic natural gas.

Raising the price of old gas to "just and reasonable" levels that will allow the additional recovery of old reserves as discussed in C.S. Matthews' study will provide significant economic benefits to the U.S. public. Money spent domestically instead of abroad results in higher government revenues from state and federal royalties, severance taxes, and income taxes. Additionally, money spent domestically increases domestic employment opportunities.

---

* Refer to C. S. Matthews' study in appendix to D. G. Russell's Senate testimony September 19, 1985.

Because it is assumed that natural gas will continue to compete with alternate fuels at the burner tip, switchable consumers will experience no increased direct costs as fuels are substituted. However, the fixed cost of the natural gas transportation and distribution systems is incorporated into the systems' cost of service and allocated on a throughput basis. Consequently, reduced throughputs will result in an increased unit charge to the non switchable customers.

It might be argued that imports of Canadian gas could be substituted for the old gas reserves and use the existing transportation and distribution network. However, Canadian flow routes are significantly different from those of the old gas which are presently connected and flowing. For Canadian gas to replace fully our estimated 1.7 TCF/yr. of old gas would require significant expansions of the existing transmission system. The costs of these expansions ultimately fall on the natural gas consuming public.

ANALYSIS

Cost Of Imports

Assumptions

- If prices are not raised to just and reasonable levels, 31-37 TCF (use 34) are not recovered over the next 20 years.
- 34 TCF ÷ 20 years = 1.7 TCF/Yr. incremental volume.
- The natural gas burnertip price equilibrates with the delivered residual fuel oil price.
- GNP deflators, conversion factors, future crude and residual fuel oil prices are based on DRI's forecast of September 4, 1985.

Calculations

- Residual fuel price x gas equivalent price x 1.7 TCF/Yr. x 10 Yrs.
  = $50.5 Billion (1984$) Cost of Imports

Cost To Consumers of Under Utilized Transportation

Assumptions

- Transportation and distribution cost is the difference between the burnertip price and the natural gas wellhead price.

- The fixed cost of the transportation and distribution system is estimated at 80%. Thus, the cost to be borne by the consumer is the difference between residual fuel at the burnertip and wellhead gas multiplied by 80% (or less the 20% variable cost).

- The natural gas wellhead price forecast is based on DRI's average Lower-48 price for gas.

Calculations

First 10 years

- Gas wellhead price x 1.7 TCF/Yr. x 10 Yrs. = $34.1 Billion (1984$)

- Cost of residual fuel at the burnertip less gas wellhead price = $50.5 - $34.1 = $16.4 Billion

- ($50.5 Billion - 34.1 Billion) x 80% = $13.1 Billion Net Cost to Consumers

Second 10 years

- Although domestic alternate fuels, rather than imported residual fuel oil, may be substituted for additional old gas recovery, the transportation fixed cost would continue to be recovered with less throughput.

- Another Potential $12.2 Billion Cost to Consumers

Amoco Corporation
200 East Randolph Drive
Post Office Box 5910A
Chicago, Illinois 60680
Planning, Economics & Development
312-856-6823

Theodore R. Eck
Chief Economist

January 23, 1986

The Honorable Senator Don Nickles
Chairman
Subcommittee on Energy Regulation and Conservation
United States Senate
Washington, D.C. 20510

Dear Senator Nickles:

Thank you for your letter of January 2, 1986. Amoco appreciates the opportunity to present its views at your subcommittee hearings on FERC Order No. 436. Attached is Amoco's reply to Senator Bingaman's questions that you transmitted. Please let us know if we can be of further assistance.

Very truly yours,

Ted Eck

Attachment

Amoco's Response to Questions from Senator Bingaman

Q: By now, I realized all of you have reviewed the Secretary of Energy's proposal to raise natural gas prices and to increase production of regulated old gas. I would like to know your initial impressions of the Secretary's proposal. Do you think FERC should implement the proposal?

A: Amoco's initial impression of the Secretary of Energy's proposal is very positive. Amoco strongly believes that for national interest FERC should raise old gas prices as suggested in the Secretary's proposal. As a result of the FERC hearings on the Secretary's proposal, it may be necessary to make minor modifications to the proposal to make it practically workable. However, we wholeheartedly support the thrust of the Department of Energy (DOE) proposal.

FERC has the authority to raise old gas prices to a just and reasonable level. Raising old gas prices would eliminate waste and economic inefficiencies. The DOE estimates that the proposal would result in eventually 34 trillion cubic feet (TCF) of additional old gas being produced, which would otherwise be lost forever. This additional domestic gas supply would provide lower cost gas for consumers and reduce oil and gas imports. The reduced oil and gas imports would reduce our balance-of-payments deficit and lessen our vulnerability to outside supply disruptions.

Complete decontrol of old gas by the Congress would be the best solution. Until that happens, however, raising old gas prices, is the best alternative. We ask you and your committee to strongly urge FERC to raise the old gas prices as suggested in the Secretary's proposal.

Q: With the reissuance of the block billing proposal, how do you see the new proposal affecting our development and exploration efforts for natural gas. I asked this same question at our September hearing and there was generally consensus that we would see a 30 percent cut in natural gas production. Do you think that percentage will change with the reissued proposal? What impact do you think it will have?

A: The revised block billing proposal is expected to have essentially the same detrimental impact on the U.S. gas exploration and development as the original block billing proposal. Also, block billing is unlawful. FERC should be urged to remove the cloud of uncertainty hanging over the gas industry by immediately rejecting the block billing proposal.

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

1101 SIXTEENTH ST., N.W.
WASHINGTON, D. C. 20036
[illegible]

WM. C. ANDERSON
VICE PRESIDENT
POLITICAL AND LEGISLATIVE
RELATIONS

January 24, 1986

Senator Don Nickles, Chairman
Subcommittee on Energy Regulations
& Conservation
Subcommittee on Energy & Natural
Resources
358 Dirksen Office Building
Washington, D.C. 20510

Dear Senator Nickles:

Attached are Ray Hefner's answers to Senator Bingaman's questions as per your letter January 2, 1986.

Sincerely,

Wm. C. Anderson

Wm. C. Anderson

bcc: Raymond H. Hefner, Jr.

Answers of

Raymond H. Hefner, Jr.
Chairman, Independent Petroleum Association of America

to

Supplemental Questions of
Senator Bingaman

Q. By now, I realized all of you have reviewed the Secretary of Energy's proposal to raise natural gas prices and to increase production of regulated old gas. I would like to know your initial impressions of the Secretary's proposal. Do you think FERC should implement the proposal?

A. Our initial impression is favorable and we believe the FERC should move to implement such a proposal. IPAA continues to support the ultimate price decontrol of all natural gas within the framework of existing contracts. If a contract expires or is voluntarily renegotiated between the two parties, market forces, not government regulations, should be the guiding factor in what the new contract contains.

Q. With the reissuance of the block billing proposal, how do you see the new proposal affecting our development and exploration efforts for natural gas. I asked this same question at our September hearing and there was general concensus that we would see a 30% cut in natural gas production. Do you think that percentage will change with the reissued proposal? What impact do you think it will have?

A. We repeat our belief that block billing, in its orginal or reissued forms, would have detrimental impact on producers revenues and thus, future production as a result of reduced drilling. We hope the FERC will take action soon to end further consideration of block billing.

TIPRO

Texas Independent Producers & Royalty Owners Association

TIPRO

January 23, 1986

The Honorable Don Nickles
United States Senate
Room SH 5754
Washington, D.C. 20510

Dear Senator Nickles:

Thank you for your letter of January 2 requesting response to two inquiries raised by Senator Bingaman.

You have asked for TIPRO's initial reaction to the DOE proposal to eliminate vintaging of old gas and raise the price ceilings for such gas to NGPA Section 109 levels.

TIPRO has always supported the decontrol of all gas supplies. And we are quite naturally intrigued by any proposal which might ease or eliminate ill-conceived government controls.

On the other hand, we recognize that the DOE proposal is not the same as comprehensive decontrol legislation. The DOE proposal must be considered in the context of a broad regulatory system which would still be in place even if the proposal were adopted. For example, TIPRO believes the Commission must weigh the benefits of raising the ceiling price on old gas against the possible detrimental effect it might have on the incentive-priced gas which Congress established in 1978 and upon which independent producers have since relied.

A number of TIPRO members are also concerned that the proposal could lead to old gas prices that exceed market clearing levels. This may or may not be a realistic prospect, and there may or may not be ways to modify the proposal in a way to head off any such possibility. However, if old gas prices were to rise above market clearing levels, prices for new supplies could be driven down to the point that producers will have no incentive to look for the inventories that consumers will be demanding in the future.

TIPRO will be reflecting upon these initial considerations between now and the February 25 deadline for public comments on the DOE proposal. We will be happy to furnish you a copy of our comments when they are filed with the Commission.

On the second matter relating to block billing, TIPRO has strongly opposed this pricing concept before FERC. It is our position that isolation of low-priced gas would create undue downward pressure on incentive-based prices for gas developed under the NGPA as well as going prices for new gas discoveries. (We see nothing in the Commission's reissuance of the block billing proposal which would change our position in this regard). This problem would adversely impact small independent producers who explore for new gas, have developed incentive-priced reserves under the NGPA and are too small to influence pipeline contractual behavior.

We are cautiously optimistic that the block billing concept may be indefinitely sidetracked. We certainly hope so. Should, however, the concept be renewed, we shall be happy to submit additional comments in response to your inquiry.

Respectfully yours,

John E. Watson (by AS)

John E. Watson
Chairman, TIPRO FERC Regulation Task Force

JAW/mk

CIG Colorado Interstate Gas Company
P.O. BOX 1087 • COLO. SPGS., CO 80944 • (303) 473-2300

PETER J. KING, JR.
Vice Chairman

January 20, 1986

The Honorable Don Nickles, Chairman
Committee on Energy and Natural
  Resources
Subcommittee on Energy Regulation
  and Conservation
United States Senate
Washington, D.C.   20510

Dear Mr. Chairman:

In your January 2 letter, you and Senator Bingaman requested my initial thoughts on the Secretary of Energy's two-part proposal to replace vintaging of low-cost price-controlled gas with a single, higher ceiling price and to establish incentive prices for the enhanced recovery of certain categories of "old gas."

The Secretary believes his proposal will lower gas prices paid by consumers and encourage the recovery of old gas that otherwise would be left in the ground because of the low maximum lawful price provided under the Natural Gas Policy Act. INGAA is analyzing this proposal and assessing its impact. We will prepare comments to file with the Federal Energy Regulatory Commission (FERC or Commission) on February 25, 1986. Copies will be made available to you at that time.

At this stage of our analysis, we cannot conclude that the Secretary's proposal would achieve the stated goals. It appears that adoption of the rule as proposed would adversely impact not only the interstate natural gas pipeline industry, but the ultimate consumer as well. We anticipate that INGAA's comments will, among other points, address the following:

1) While the FERC has authority under the NGPA (Section 104 and 106) to raise the ceiling price of old gas to just and reasonable levels, the basis for such increased prices must be cost, after which non-cost factors, including market prices, may be considered. Just and reasonable prices could not be based solely on non-cost factors.

2) The proposal would improperly permit producers to abrogate their contracts with pipelines if pipelines are unwilling to pay the proposed ceiling price and the producer can get a price higher than the pipeline's offer elsewhere (a producer "market-out" provision).

3) The proposal ignores the high-cost, high-take problem contracts that would not respond to the market pressure created by raising old gas prices and thus would adversely impact the marketing initiatives of interstate pipelines and the ultimate consumer.

4) The proposal overlooks some material facts that could adversely impact the ultimate consumer and preclude achieving the goals set out by the Secretary:

    a) the vast majority of old gas contracts contain area rate clauses, and the extent to which these clauses could be interpreted to entitle producers to receive the proposed ceiling price without contract renegotiation is critical, and unclear, and

    b) although development of old gas reserves may be enhanced, triggering prices to the new ceiling could actually hinder production of old gas because the proposed ceiling price, which is well in excess of current market-clearing levels, would also be in excess of the current weighted average cost of gas (WACOG) for pipelines serving 55 percent of the interstate market.

5) While the FERC has the authority to establish incentive prices for gas produced under conditions presenting extraordinary risks and costs, the Secretary's proposal would provide incentives for gas development that entail neither extraordinary risks nor extraordinary costs.

As I indicated, we are preparing INGAA's comments. These are our preliminary thoughts relative to the Secretary's proposal. We appreciate your inquiry and will be happy to meet with you and discuss further our position on RM86-3 as well as the need for natural gas legislation.

Sincerely,

PJKing

Peter J. King, Jr.
Vice Chairman
Colorado Interstate Gas Company
On behalf of the Interstate
Natural Gas Association of America

cc: Senator Bingaman

PJK:bbc

Transco
Energy Company

2700 Post Oak Boulevard
P. O. Box 1396
Houston, Texas 77251
713-871-8000

January 24, 1986

The Honorable Don Nickles
Chairman, Subcommittee on Energy
  Regulations and Conservation
United States Senate
Washington, D.C. 20510

Re: Secretary of Energy's Proposal to Raise "Old Gas" Ceiling Prices and Establish Incentive Prices for Certain "Old Gas"

Dear Senator Nickles:

I have received your letter of January 2, 1986, which asks that I provide to the Subcommittee on Energy Regulation and Conservation a written response to several questions asked by Senator Bingaman. The specific questions addressed to me concern Transco's initial impressions of the Secretary of Energy's proposal to raise ceiling prices for "flowing old gas" and to establish incentive prices for certain categories of "old gas".

While Transco has not yet completed its study of the Secretary's proposal, our preliminary review leads us to the conclusion that it is unrealistic in its present form and would result in significantly higher gas costs to consumers if it were implemented without modification. Transco continues to believe that the only ultimate solution to problems facing the natural gas industry is complete deregulation of wellhead natural gas prices accompanied by a legislative cure for the take-or-pay and indefinite price escalation problems that restrict the ability of gas to compete in the market place. If an administrative solution is to be attempted, however, it would be acceptable only if, in addition to raising "old gas" ceiling prices, it contained a mechanism for effectively lowering overall gas prices to market-clearing levels and solved those same take-or-pay and indefinite price escalator problems.

Any action, whether legislative or administrative, must result in effective deregulation of all gas prices. This is because much of the cause for the industry's current problems lies with existing ceiling prices that far exceed current market prices. Ceiling prices for some regulated gas not addressed by the Secretary's proposal are now at levels more than 100% to 200% greater than current market prices. For example, while Transco estimates that today's market-clearing wellhead price in its production area is $2.15 per MMBtu, or less, the January 1986 maximum lawful price for NGPA .102(d) gas is currently $4.17 per MMBtu. This particular category of gas makes up a large percentage of the non-market-responsive current deliverability available to Transco. Other regulated prices are even higher. The Secretary's proposal fails, however, to recognize the existence of, let alone deal with, long-term gas purchase contracts that provide for these high regulated prices. And, since the January 1986 maximum lawful price for NGPA "post-1974" gas is $2.54 per MMBtu, the Secretary is proposing new ceiling prices that at their inception are already far above market clearing levels. His proposal nowhere recognizes this fact. The Secretary's proposal, by itself, will do nothing more than aggravate existing price and take-or-pay problems. Any action which proposes only to raise "old gas" prices without effectively providing the means for lowering other gas prices, can only damage the industry.

The Secretary's proposal could be made more acceptable if modified in a manner which recognized the problems discussed above. For example, the coupling of a FERC mandate of a least cost purchasing strategy for interstate pipelines with the proposal to raise "old gas" prices could provide the mechanism for effectively lowering overall gas prices, and the consumer's gas costs.

Another approach, though probably less effective, would be to discard the "good faith negotiation rule" as currently contained in the Secretary's proposal, and replace it with a requirement that a producer's access to the new higher ceiling prices be conditioned on his renegotiation of high-cost contract prices to market clearing levels, to the extent the producer has contracts with a pipeline that provide for prices above market levels. Such a modification to the Secretary's proposal would provide an incentive for producers to renegotiate high-cost gas purchase contracts, and consequently enable pipelines to pay higher prices for "old gas" supplies.

Such modifications, however, would still result in only a marginally acceptable proposal. More comprehensive action such as I have described above must be taken in order to resolve all the problems associated with contracts providing for prices above market clearing levels, and to ensure consumers of a reasonably priced gas supply.

I appreciate your providing me the opportunity to speak at your Subcommittee's hearing on November 21, 1985. I hope that you will not hesitate to contact me again if you desire a more detailed discussion of Transco's views on the Secretary's proposal, or if I can be of assistance to you in any other way.

Very truly yours,

Brian E. O'Neill

Southern Natural Gas Company
Post Office Box 2563
Birmingham AL 35202 2563
205 325 7584

Hugh J Morgan Jr
Chairman of the Board

SOUTHERN NATURAL GAS

January 20, 1986

The Honorable Don Nickles
United States Senate
Washington, D.C. 20510

Dear Senator Nickles:

This will respond to your request for Southern Natural Gas Company's initial impressions of the Secretary of Energy's recent proposal to raise the prices for regulated categories of natural gas to market levels. You have also asked whether our company feels that FERC should implement the DOE proposal.

As you know from my testimony before your subcommittee on November 21, 1985, the overriding concern of Southern Natural Gas Company is the failure of the FERC to deal with the take-or-pay issue in its Orders 436 and 436-A. Absent action by the FERC in that regard, participation by Southern under Order No. 436 would greatly aggravate the critical take-or-pay problem we currently face. The Company's projected take-or-pay exposure for 1985 could be $800 million and that figure could double in 1986. We have and are continuing to negotiate with our producers to settle disputes and revise contracts to more accurately reflect the current market realities. This task has been made more difficult given the lack of incentive under Order 436 for producers to renegotiate. We certainly applaud your appreciation of this problem and your recognition of the need to remove these disincentives for pipelines to participate under Order No. 436.

Let me re-emphasize that our Company entered into its long-term gas purchase agreements to meet its certificated sales obligations. The take-or-pay provisions at issue now were included in those contracts as they had been since virtually the first contracts were signed. It is simply unacceptable for FERC to address contracts at the sales end of the pipeline without addressing these contracts at the supply end.

Our Company strongly supports competition in the marketplace. We are currently seeking a voluntary transportation program at the FERC in Docket No. CP84-342. This proposal would provide open-access transportation as well as a means of dealing with the take-or-pay issue through the imposition of a surcharge for certain transportation volumes. Unfortunately, the FERC's staff has taken the position that all such programs must be authorized under Order No. 436 and has moved to have Southern's application summarily dismissed.

A **SONAT** COMPANY

Southern has consistently supported the total deregulation of all natural gas prices at the wellhead. To the extent that the DOE proposal takes a step in that direction, we would support that effort. However, the DOE proposal, as it currently stands, would allow a producer to unilaterally abrogate its obligation to deliver relatively low-cost supplies to a pipeline by selling those supplies to another customer under a higher priced contract. Unfortunately, the proposal fails to address the high-cost contracts which exist between the producer and the purchaser.

In response to the passage of the Natural Gas Policy Act of 1978, Southern and other natural gas pipelines entered into relatively high cost gas purchase contracts in an effort to provide a reliable source of natural gas to its certificated customers. Southern, like the others, did so on the assumption that those higher prices could be rolled-in with its lower cost gas supplies to be sold at a weighted average price for system supply. If the FERC intends to allow the producers in effect a unilateral market-out of their old gas contracts then some provision must be made to allow the termination or modification of the high-cost gas purchase agreements entered into in reliance upon rolled-in pricing.

In conclusion, the take-or-pay issue is of overriding concern to Southern Natural Gas. While we are still evaluating the DOE proposal, my feeling is that it would be difficult for us to support it unless it is revised to address the severe problems created by existing high-cost gas contracts.

Thank you very much for the opportunity to offer our views on the DOE proposal.

Sincerely,

Hugh J. Morgan Jr.

Hugh J. Morgan, Jr.

William C. Terpstra
President

MIDCON CORP.

701 East 22nd Street
P.O. Box 1207
Lombard, Illinois 60148
(312) 691-3100

January 24, 1986

Senator Don Nickles, Chairman
Subcommittee on Energy Regulation
and Conservation
United States Senate
Senate Hart Building
Washington, D.C. 20510

Dear Senator Nickles:

You have requested our initial impressions of the Secretary of Energy's proposal to raise natural gas prices and to increase production of old gas.

While we certainly agree with the Department of Energy that old gas prices should be addressed, we think it should be done in the context of an overall plan which deals not only with low-cost gas contracts but also with high-cost gas.

Our current average gas costs under long-term contracts are in excess of spot gas prices. We are negotiating and marketing out where permitted to reduce our gas costs and prices to our customers. Thus, any proposal to raise the price of below-average cost supplies should also encourage the reduction of above-average cost supplies to permit pipelines to be responsive to market conditions.

The Department of Energy's proposal as drafted does not give the producer an incentive to negotiate lower prices for high-cost gas. Natural Gas Pipeline Company of America estimates if the rule is adopted as proposed, gas costs could increase approximately $350 million, or about $.45 per MCF in the first year.

We believe that all segments of the industry would benefit from a package which includes deregulation of old gas, renegotiation of contracts above current market levels and pipeline access. Proposals which do not address all of these issues will not provide either an equitable transition or balanced industry structure.

We would appreciate your assistance in creating an equitable solution and would be pleased to provide information or help such efforts.

Best wishes for the New year.

Very truly yours,

William C. Terpstra

William C. Terpstra

APPENDIX II

Additional Material Submitted for the Record

DAN QUAYLE
INDIANA

SH [illegible] HART SENATE OFFICE BUILDING
(202) 224-5623

INDIANAPOLIS OFFICE:
ROOM 447, 46 EAST OHIO STREET
INDIANAPOLIS, INDIANA 46204
(317) [illegible]

United States Senate
WASHINGTON, D.C. 20510

COMMITTEES:
ARMED SERVICES
BUDGET
LABOR AND HUMAN
RESOURCES

November 20, 1985

The Honorable Don Nickles
Chairman
Subcommittee on Energy, Regulation,
and Conservation
SH-212

Dear Don:

Attached is a letter from one of my constituents regarding natural gas and the FERC Order 436. I understand that your committee will be considering this issue on November 21. I would appreciate your including my constituent's letter as a part of the written hearing record.

Thank you for your attention to this request.

Sincerely,

Dan Quayle
U.S. Senator

DQ:mgd
Enclosure

StaleyContinental, Inc.

PLEASE REPLY TO
P.O. BOX 2513
DECATUR, IL 62525
(217) 421-3365

November 15, 1985

Honorable Dan Quayle
United States Senate
Washington, D.C. 20510

Dear Senator Quayle:

Staley Continental, Inc., through its A. E. Staley Manufacturing Company and CFS Continental, Inc. operating companies, represents over 8,500 employees in 83 facilities in 29 states. In Indiana, Staley Continental facilities represent 698 jobs. Since we are a major user of natural gas, we are concerned that these jobs may be affected by the refusal of most interstate pipelines to transport natural gas under FERC Order 436.

During the past two years, A. E. Staley Manufacturing Company has utilized "contract carriage" to purchase our natural gas supplies. Since its implementation, this program has resulted in savings of over $3½ million. We were, therefore, extremely pleased when the Federal Energy Regulatory Commission (FERC) issued Order 436. It was our hope that this initiative would "open-up" the natural gas transportation system and allow prices for natural gas to be determined by market forces. Benefits would be realized by all gas consumers -- not just large industry.

It is a severe blow to all gas users to find that most major pipeline companies are electing not to transport under Order 436. Although we are an essential agricultural user of natural gas and qualify for "Grandfather Status" under Order 319, we are faced with transportation contracts serving our Indiana plants that will terminate at the end of 1985. At this time, it is our understanding that the FERC will not recognize extensions to these contracts. In addition, we are unable to change suppliers or supply points from existing suppliers. The result of the pipeline's refusal to transport under Order 436 leaves us with a situation where existing transportation contracts cannot be renewed when they expire and our "spot market" purchase prices increasing because our transportation contracts "lock" us with specific suppliers.

We urge you to exert your influence to encourage the pipelines to transport natural gas under FERC Order 436 and to support resolutions or legislation concerned with transportation of natural gas in a nondiscriminating manner.

Thank you for your consideration.

Sincerely,

N. R. Lockmiller

N. R. Lockmiller
Manager
Government Relations

NRL:sk

JIM SASSER
TENNESSEE

COMMITTEES:
APPROPRIATIONS
BANKING, HOUSING AND URBAN AFFAIRS
BUDGET
SMALL BUSINESS

United States Senate
WASHINGTON, DC 20510

January 10, 1986

Honorable Don Nickles
Committee on Energy and Natural Resources
Subcommittee on Energy, Regulation, and Conservation
Washington, D.C. 20510

Dear Don:

I am writing on behalf of Mr. S. L. Kopald, President of Witco Chemical Corporation in Memphis. As you know, the Federal Energy Regulatory Commission's Final Rule, Order 436, has caused quite a stir in the natural gas industry.

Mr. Kopald is particularly concerned about the transportation aspect of the 436 Order. I know that you very much want to see a resolution of this situation, as I do. I would appreciate your incorporating Mr. Kopald's testimony before the House Subcommittee on Fossil and Synthetic Fuels into your subcommittee's November 21st hearing record.

Thank you for your interest in this matter.

Sincerely,

Jim

Jim Sasser
United States Senator

STATEMENT OF
MR. S. L. KOPALD
GROUP VICE PRESIDENT
WITCO CHEMICAL CORPORATION
MEMPHIS, TENNESSEE

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FOSSIL AND SYNTHETIC FUELS
COMMITTEE ON ENERGY AND COMMERCE

NOVEMBER, 1985

On behalf of Witco Chemical Corporation, I would like to thank the Subcommittee for allowing us the opportunity to enter our statement into the record presenting our views on the Federal Energy Regulation Commission's Final Rule, Order No. 436.

Witco Chemical Corporation operates 48 domestic plants, employing 6500 people, in the production of specialty chemical and petroleum products for use in the manufacture of such goods as plastics, rubber, textiles, cosmetics, food processing and agriculture. Foreign competition in these markets is keen, and Witco often competes with countries who have significantly lower energy costs. Witco uses large quantities of natural gas in 75% of its facilities and it is imperative that Witco's energy costs be maintained at a level which will allow our products to continue to be competitive.

As a case in point, Humko Chemical, a division of Witco, located in Memphis, Tennessee, has been the beneficiary of self-help transportation gas for the past twelve months through a gas transport contract with Texas Gas Transmission Corporation ("Texas Gas"). During 1985, we have been able to reduce our energy costs 15% to 20% as compared to 1984 energy costs and have negotiated a contract with Texas Gas that will enable us to reduce our costs by an additional 15% to 20% for 1986. However, on December 1, 1985, our initial gas transport contract expired and Texas Gas immediately halted transportation service to Humko. Texas Gas has been reluctant to finalize the contractual arrangements for new transportation service due to the non-discriminatory access conditions they feared would be imposed by Order No. 436. Humko was forced to obtain temporary alternative supplies of more expensive gas from Memphis Light, Gas and Water's system supply. This has resulted in a loss of approximately $2,350.00 in energy costs per day. (Humko will face serious difficulty in maintaining a competitive market price if this condition continues to persist.)

The repercussions of the halt of transportation service by the pipelines, including Texas Gas, as they weigh the advantages and disadvantages to their systems under Order No. 436 means that Witco, among others, will be caught between competing objectives: the Commission's desire to open the market by providing non-discriminatory access to transportation by interstate pipelines, and the interstate pipelines' refusal to be rushed into a major decision by having to proceed with transportation service due to the new operating and rate conditions they feared would be imposed by Order No. 436.

We respectfully ask this Subcommittee to explore any options, including new legislation, which would ensure that the means exist for any end-user to have its gas transported.

STATEMENT

of

DOMESTIC PETROLEUM COUNCIL

before

ENERGY REGULATION AND CONSERVATION SUBCOMMITTEE

of the

SENATE ENERGY & NATURAL RESOURCES COMMITTEE

NOVEMBER 21, 1985

The Domestic Petroleum Council (DPC) is a trade association comprised of 20 mid-sized domestic producers of natural gas and oil. It appreciates the opportunity offered by the Energy Regulation and Conservation Subcommittee of the Senate Energy and Natural Resources Committee to comment on the status of the natural gas industry and the effects of the Federal Energy Regulatory Commission's (FERC) October 9 ruling which promulgated Order 436.

That Order, which established a new transportation program for natural gas pipelines, has added tremendous new uncertainties into an already uncertain natural gas market. The DPC believes the FERC possesses neither the statutory nor the regulatory tools necessary to adequately address the problems that exist in the natural gas marketplace. While the DPC applauds the FERC's efforts to increase access to natural gas markets, overall their attempt to do so in Order 436 merely further clouded an already murky situation. The ability and responsibility for ameliorating the inequities of the current gas markets resides in Congress. The only practical solution is the total decontrol of natural gas at the wellhead, the establishment of equal access to the pipeline network for both buyers and sellers of natural gas and the removal of natural gas demand constraints.

I. DECONTROL

The existence of an old gas "cushion" remains at the heart of the problems of the natural gas markets. When natural gas was in short supply in the interstate market, it was expected by all participants in the industry that the existence of the cushion would lead to a fly-up of gas prices upon partial decontrol under the Natural Gas Policy Act (NGPA). The reasons the fly-up did not occur have already been detailed to this Committee. Nevertheless, the distortions caused by the presence of the old gas cushion still affect the market for unregulated sales. So long as this cushion exists neither the producer nor the consumer of gas will be able to accurately determine what that commodity is truly worth. Without accurate price signals we will doom ourselves to the recurrent cycles of shortage and surplus that have plagued the industry in the past decades. Such signals are not available until natural gas is totally decontrolled at the wellhead.

II. EQUAL ACCESS

Even total decontrol of natural gas at the wellhead would be ineffective, however, without equal and non-discriminatory access, without unnecessary and unfairly burdensome conditions, to the nation's pipeline network. The DPC views such access as vital to both buyers and sellers of gas and the maintenance of a national marketplace. It is a prerequisite for allowing meaningful price competition in all natural gas markets. Today, producers are willing to sell gas at market prices to willing buyers. The availability of reasonably priced gas, in turn, has enhanced the competitiveness of numerous U.S. businesses. The challenge for the natural gas system is to forge a transporation system that puts these buyers and sellers together in the most efficient and cost effective manner.

Indeed, non-discriminatory access has become vital if a viable domestic exploration industry is to be preserved. The recent experience of the DPC member companies has been that the vast majority of gas from newly discovered wells has been sold directly to industrial and utility buyers. This is because the historical pipeline markets have not been purchasing new supplies over the past two years. The DPC expects this inability to market new gas to interstate pipelines to continue for, at least, the next several years. The decline in gas prices has already had a dramatic effect on the economics of exploration for new gas supplies. If the marketing of these new supplies is further encumbered and delayed, the result on exploration and production activities could well be catastrophic. Hence, both producers and consumers are benefited by direct access.

III. FERC ORDER 436

As noted above, to the extent that FERC Order 436 increases access to natural gas markets by encouraging pipelines to provide non-discriminatory transportation services to third party shippers, the DPC vigorously supports it. The DPC, however, opposes the Order to the extent that it violates the sanctity of two-party contracts. The sanctity of contracts, and the right to freely renegotiate the terms and conditions of those contracts is an important cornerstone of the free enterprise system. Reliance on contracts is necessary if businesses are to make the investments necessary to assure a continuing supply of natural gas. Any government intervention in contracts between producer and pipelines or between pipelines and customers must be avoided at all cost.

The operation of the contractual system, including renegotiation, in the natural gas market has proven to be been extremely effective particularly in the intrastate market. Indeed, in nearly all situations, renegotiation is the preferable alternative to resolving market oriented contract disputes. Neither Congress nor the FERC should unfairly tip the balance of these renegotiations. Producers have renegotiated price and take or pay provisions in return for guarantees of cash flow to be generated by pipeline transportation of released gas to new markets. These agreements have been placed in jeopardy by Order 436.

Pipelines, which purchased gas supplies in reliance on customer demand/forecasts are now faced with the unenviable choice of losing revenue by not transporting the gas or facing the legal wrath of their suppliers when their contract demand is arbitrarily and unilaterally released. The best alternative to Order 436 is for FERC to open the doors necessary to expedite mutually agreeable contract renegotiations between pipelines and their customers.

IV. BLOCK BILLING

The DPC opposes the FERC's attempt to repeal the rolled-in pricing policy of the NGPA in favor of "Block Billing" for natural gas. Such a system could cause serious shortages of natural gas and lead to severe economic hardship not only in the consuming areas of the country, but in the producing areas as well.

Block Billing would effectively deny producers the remaining production incentives contained in the NGPA. It would also unfairly tip the balance of contract negotiations in favor of pipeline purchasers thereby denying to producers any remaining contract price protection. Block Billing will create classes of advantaged and disadvantaged consumers depending upon the rations of cheap gas given to the local distribution company.

For producers, Block Billing will further reduce cash flow. That, in turn, will further reduce drilling expenditures and exacerbate an already serious capital crisis in the natural gas producing industry. Finally, Block Billing will not send accurate price signals to either the producer or the consumer of gas. Those consumers with distribution companies having a relatively larger proportion of cheap gas will see rolled-in prices which are too low. Producers, on the other hand, will see below market prices for new gas. This back door re-regulation will lead to the same combination of excess demand and reduced supply which resulted in the shortages of 1976-1977.

V. PROPOSED CONGRESSIONAL ACTIONS

The natural gas industry is in a state of chaos. Spot prices on the U.S. Gulf Coast have fallen over $1.00/mcf in the last 10 months. Gas transportation to many low priority end-users and utilities was cut off on November 1, 1985, in some cases with only hours' notice. These same customers are being forced to accept the same high-priced system supply gas from pipelines that they have struggled to avoid.

The Congress should encourage the FERC to re-evaluate Order 436 and remove from it those aspects which interfere with two-party contracts. Further, those portions of Order 436 which unfairly disadvantage pipelines for opening their systems to transportation of gas for others should also be reconsidered by the FERC.

Congress should also ensure that FERC does not promulgate the unjustified, unwarranted and dangerously regressive practice of Block Billing. Market forces have brought gas prices down at the wellhead. Opening the pipeline system to non-discriminatory transportation will insure that the benefits of these price reductions are passed on to all consumers. The price signals freely passed between gas sellers and gas buyers, without the artificial barrier of Block Billing, will allow producers to prudently expend the appropriate sums of money necessary to produce future supplies of gas.

Finally, Congress, not the FERC, must get on with the only long term solution to rationality in the natural gas markets, that of decontrol of natural gas at the wellhead combined with nondiscriminatory access to the transportation network and a repeal of demand constraints contained in the Powerplant and Industrial Fuel Use Act. There will never be a better time to decontrol this market. Without such decontrol we are committing ourselves to relive the shortages and market distortions of the past.

STATEMENT OF ROGER R. REGELBRUGGE

CHIEF EXECUTIVE OFFICER
GEORGETOWN STEEL CORPORATION
BEFORE THE SENATE SUBCOMMITTEE ON
ENERGY & NATURAL RESOURCES

FERC RULE ON NATURAL GAS PIPELINES

NOVEMBER 21, 1985

MR. CHAIRMAN, AND MEMBERS OF THE SUBCOMMITTEE - MY NAME IS ROGER R. REGELBRUGGE. I AM CHIEF EXECUTIVE OFFICER OF GEORGETOWN STEEL CORPORATION AND ITS PARENT, GEORGETOWN INDUSTRIES, INC. I AM APPEARING TODAY ON BEHALF OF GEORGETOWN STEEL CORPORATION. GEORGETOWN STEEL APPRECIATES THE OPPORTUNITY TO PRESENT ITS VIEWS TO THIS SUBCOMMITTEE ON ORDER NO. 436.

I AM SURE YOU ARE AWARE OF THE DIFFICULTIES THE STEEL INDUSTRY IN THE UNITED STATES HAS BEEN FACED WITH IN RECENT YEARS, AND HOW TOTAL EMPLOYMENT IN THE INDUSTRY HAS BEEN REDUCED TO LESS THAN HALF OF WHAT IT WAS 5 YEARS AGO. THE UNINTERRUPTED AND UNCONTROLLED FLOW OF IMPORTS OF STEEL PRODUCTS AT PRICES SUBSIDIZED BY FOREIGN GOVERNMENTS CONTINUES TO PUT THE LONG-TERM VIABILITY OF THE UNITED STATES STEEL INDUSTRY IN SERIOUS JEOPARDY. FURTHER, CERTAIN ACTIVITIES OF THE ENVIRONMENTAL PROTECTION AGENCY AND OTHER GOVERNMENTAL AGENCIES HAVE DRAMATICALLY INCREASED THE COST OF MAKING STEEL IN THIS INDUSTRY, THE ONLY EFFECT OF WHICH HAS BEEN TO IMPROVE THE ENVIRONMENT FOR OUR UNEMPLOYED TO ENJOY.

I PRESUME THAT YOU HAVE HEARD MUCH TODAY ABOUT THE DETAILS AND NUANCES OF ORDER NO. 436 FROM THOSE MORE FAMILIAR WITH THE NATURAL GAS INDUSTRY THAN I AM. I AM ONLY HERE TO TELL YOU ABOUT THE EFFECT THAT ORDER NO. 436 HAS HAD ON GEORGETOWN STEEL. THE EFFECT HAS BEEN TO INCREASE THE COST OF NATURAL GAS SUPPLIES TO GEORGETOWN STEEL BY OVER 20%. ONCE AGAIN, THE FINANCIAL VIABILITY OF GEORGETOWN STEEL IS THREATENED BY THE HIGH COST OF NATURAL GAS, DESPITE THE AVAILABILITY OF LOWER-PRICED GAS.

GEORGETOWN STEEL OPERATES A DIRECT REDUCTION PLANT IN GEORGETOWN, SOUTH CAROLINA. IT IS THE ONLY ONE OF ITS TYPE IN THE UNITED STATES. THE PLANT USES NATURAL GAS AS A CHEMICAL FEED-STOCK TO CONVERT IRON ORE INTO VIRTUALLY PURE IRON FOR USE IN OUR STEEL-MAKING PROCESSES. AT A TIME WHEN THE UNITED STATES STEEL INDUSTRY IS BEING CRITICIZED FOR THE POOR QUALITY OF ITS PRODUCT, GEORGETOWN STEEL HAS MANAGED TO OPERATE THIS STATE OF THE ART PLANT AND TO PRODUCE HIGH-QUALITY STEEL COMPETITIVE WITH FOREIGN STEEL. WE WERE FORCED TO SHUT THIS PLANT DOWN AND LAY OFF PERSONNEL IN 1982 DUE TO PROHIBITIVELY HIGH NATURAL GAS COSTS RESULTING FROM THE NATURAL GAS POLICY ACT OF 1978. IN 1984, WE WERE ABLE TO RESTART THE OPERATION LARGELY AS A RESULT OF THE AVAILABILITY OF LOWER-COST NATURAL GAS ON THE SPOT MARKET AND THE SIGNIFICANT SALARY AND WAGE CONCESSIONS MADE BY OUR EMPLOYEES. ONLY TWO MONTHS AGO, WE ENTERED INTO A NEW NATURAL GAS PURCHASE AGREEMENT FOR LOWER-COST NATURAL GAS WITH A GAS PRODUCER AND

NEGOTIATED TRANSPORTATION CONTRACTS WITH AN INTERSTATE PIPELINE, SOUTHERN NATURAL GAS COMPANY, AND AN INTRASTATE PIPELINE, SOUTH CAROLINA PIPELINE, FULLY EXPECTING THIS GAS TO BE AVAILABLE FOR SEVERAL YEARS. THE AVAILABILITY OF THIS LOWER-COST NATURAL GAS WAS MAKING A VERY SIGNIFICANT CONTRIBUTION TO GEORGETOWN STEEL'S ABILITY TO REMAIN FINANCIALLY VIABLE IN A VERY DEPRESSED STEEL INDUSTRY.

FOLLOWING THE ISSUANCE OF ORDER NO. 436, TRANSPORTATION OF THIS LOWER-COST NATURAL GAS WAS INTERRUPTED BY SOUTHERN NATURAL ON OCTOBER 31, 1985. IN ORDER TO CONTINUE OPERATIONS, GEORGETOWN STEEL WAS FORCED TO PURCHASE NATURAL GAS FROM SOUTH CAROLINA PIPELINE AT A COST 20% HIGHER THAN THE PRICE OF THE LOWER-COST NATURAL GAS. THE INTERRUPTION OF TRANSPORTATION BY SOUTHERN NATURAL WAS A DIRECT RESULT OF THE ISSUANCE OF ORDER NO. 436 AND SOUTHERN NATURAL'S DECISION THAT IT COULD NOT CONTINUE TO PROVIDE TRANSPORTATION TO GEORGETOWN STEEL UNDER ITS TERMS. THIS HAS OCCURRED DESPITE THE FACT THAT NO LESS THAN FOUR PRODUCERS ARE WILLING TO SELL GAS TO GEORGETOWN STEEL AT LOW MARKET PRICES, SOUTH CAROLINA PIPELINE IS WILLING TO TRANSPORT THE GAS, AND SOUTHERN NATURAL WOULD TRANSPORT THE GAS ABSENT ORDER NO. 436.

I AM NOT HERE TO DEBATE THE MERITS OF ORDER NO. 436. I CAN ONLY TELL YOU THAT IN THIS INSTANCE IT HAS HALTED THE SALE, TRANSPORTATION AND PURCHASE OF LOWER-COST NATURAL GAS IN A TRANSACTION WHICH EVERYONE, INCLUDING THE FEDERAL ENERGY REGULATORY COMMISSION, AGREES HAS BEEN BENEFICIAL TO ALL PARTICIPANTS AND IS IN THE PUBLIC INTEREST.

GEORGETOWN STEEL FULLY SUPPORTS THE COMMISSION'S GOALS IN ORDER NO. 436 TO "...INCREASE NOT DECREASE, THE FLEXIBILITY OF PRODUCERS AND PIPELINES TO MEET CONSUMER DEMAND UNDER SELF-IMPLEMENTING TRANSPORTATION PROGRAMS." HOWEVER, ORDER NO. 436 HAS ACTUALLY FRUSTRATED THE ATTAINMENT OF THIS GOAL. ITS EFFECT HAS BEEN TO INSURE THAT WHAT THE COMMISSION CALLS "UNDULY DISCRIMINATORY TRANSPORTATION" BY INTERSTATE PIPELINES DOES NOT OCCUR BY PRECLUDING MOST SELF-IMPLEMENTING TRANSPORTATION BY INTERSTATE PIPELINES. THIS SIMPLY MAKES NO SENSE, AND IS CAUSING UNNECESSARY HARDSHIP TO ALL, AND TO GEORGETOWN STEEL IN PARTICULAR. FUNDAMENTALLY, THE COMMISSION SHOULD BE ENCOURAGING, NOT HINDERING, THE TRANSPORTATION OF NATURAL GAS WHICH PRODUCERS WANT TO SELL AT LOW, MARKET PRICES, INTERSTATE PIPELINES WANT TO TRANSPORT, AND GEORGETOWN STEEL WANTS TO BUY.

I'VE HEARD MUCH TALK CONCERNING THE "TAKE-OR-PAY" PROBLEMS FACED BY INTERSTATE PIPELINES, AND THEIR RELUCTANCE TO TRANSPORT GAS UNDER ORDER NO. 436 BECAUSE THOSE PROBLEMS WOULD WORSEN. HOWEVER, INTERSTATE PIPELINES SHOULD NOT BE PROTECTED FROM THE EFFECTS OF BUSINESS DECISIONS THEY HAVE MADE, JUST AS GEORGETOWN STEEL WAS NOT PROTECTED FROM THE EFFECTS OF ITS BUSINESS DECISIONS. WITH FULL RECOGNITION OF THE SCOPE OF THE TAKE-OR-PAY PROBLEMS FACED BY INTERSTATE PIPELINES, NEITHER CONGRESS NOR THE COMMISSION SHOULD INJECT THEMSELVES INTO THE ON-GOING NEGOTIATIONS ON TAKE-OR-PAY ISSUES BETWEEN INTERSTATE PIPELINES AND PRODUCERS. THE COMMISSION HAS ALREADY REJECTED THE

IDEA OF CONDITIONING PRODUCER ACCESS TO TRANSPORTATION ON A GRANT OF TAKE-OR-PAY RELIEF. HOWEVER, THE COMMISSION HAS FACILITATED TAKE-OR-PAY NEGOTIATIONS THROUGH REFERENCE IN ORDER NO. 436 TO ITS TAKE-OR-PAY POLICY STATEMENT, AS WELL AS THE PROVISIONS IN ORDER NO. 436 WHICH PROVIDE FOR EXPEDITED CONSIDERATION OF PRODUCER ABANDONMENT APPLICATIONS FOR BOTH OLD AND NEW GAS. GEORGETOWN STEEL BELIEVES THAT INTERSTATE PIPELINES AND PRODUCERS SHOULD BE FREE TO NEGOTIATE THE TERMS OF TAKE-OR-PAY SETTLEMENTS, RATHER THAN BEING FORCED INTO A CONDITION THAT MAY NOT BE AS MUTUALLY BENEFICIAL. IN FACT, CONDITIONS IMPOSED BY CONGRESS OR THE COMMISSION ON TAKE-OR-PAY NEGOTIATIONS WHICH REMOVE BARGAINING ITEMS COULD IMPEDE THOSE NEGOTIATIONS. CONGRESS AND THE COMMISSION CAN ENCOURAGE RESOLUTION OF TAKE-OR-PAY PROBLEMS BY FACILITATING NEGOTIATION BY THE AFFECTED PARTIES, NOT BY DICTATING A UNIFORM SOLUTION.

IT IS VIRTUALLY IMPOSSIBLE TO OPERATE A BUSINESS AS COMPETITIVE AS THE STEEL BUSINESS IN A PROPER AND PROFITABLE MANNER, TO THE BENEFIT OF EVERYONE, WHEN THE RULES OF THE GAME ARE CONTINUALLY CHANGING WITHOUT WARNING THROUGH GOVERNMENT INTERVENTION. WHAT IS DESPERATELY NEEDED IN BOTH THE ENERGY INDUSTRY AND THE STEEL INDUSTRY IS STABILITY. THE FEDERAL ENERGY REGULATORY COMMISSION, THROUGH ORDER NO. 436, HAS ONCE AGAIN INJECTED TOTAL INSTABILITY INTO THE NATURAL GAS INDUSTRY. IN THE GUISE OF INCREASING COMPETITION, IT HAS UNINTENTIONALLY ELIMINATED IT.

CONGRESS SHOULD TAKE WHATEVER ACTION IT CAN TO ASSURE THAT SELF-IMPLEMENTING TRANSPORTATION CAN CONTINUE UNTIL THE FULL IMPLICATIONS OF ORDER NO. 436 CAN BE BROUGHT TO THE ATTENTION OF CONGRESS AND THE COMMISSION. TRANSPORTATION OF LOWER-COST NATURAL GAS TO GEORGETOWN STEEL AND OTHERS SHOULD BE PERMITTED.

THANK YOU.

STATEMENT OF
HOWARD C. HOMEYER
PRESIDENT, TEXAS EASTERN GAS PIPELINE COMPANY
A DIVISION OF TEXAS EASTERN TRANSMISSION CORPORATION
BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION OF THE SENATE ENERGY AND NATURAL RESOURCES COMMITTEE

December 13, 1985

STATEMENT OF HOWARD C. HOMEYER
EXECUTIVE SUMMARY

Texas Eastern stands ready to provide open access transportation under Order No. 436 but only if this action does not vest in its sales customers the right of unilateral contract abrogation. The provisions of Order No. 436 providing for such abrogation should be eliminated as they relate to transportation under Section 311 and the Section 7 blanket certificate authority. These provisions are illegal and inimical to the interests of producers, pipelines, distributors, and consumers. The adjustment of contracts to current market conditions should be achieved through bilateral contract negotiations between pipelines and their customers.

In Order No. 436, the Commission has jeopardized the development of long-term supplies and reserves and, in turn, a pipeline's ability to provide a secure low cost and long-term supply base for its customers. While short-term (spot market) supplies are a valid component of a customer's gas mix, they can be adequately provided to the market place through open access transportation without the need for abrogating pipeline sales contracts.

The Commission believes it has discretion to authorize unilateral contract abrogation as a consequence of a pipeline undertaking Section 311 transportation. Texas Eastern does not believe the Congress intended to vest the Commission with such discretion.

Texas Eastern is opposed to any Federal action which abrogates existing contractual relationships, including the contractual relationships with its producers.

STATEMENT OF
HOWARD C. HOMEYER
PRESIDENT, TEXAS EASTERN GAS PIPELINE COMPANY
A DIVISION OF TEXAS EASTERN TRANSMISSION CORPORATION
BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION OF THE SENATE ENERGY AND NATURAL RESOURCES COMMITTEE

My name is Howard C. Homeyer. I am President of Texas Eastern Gas Pipeline Company. Texas Eastern's gas pipeline is a 9,000 mile interstate pipeline system extending from the Mexican border at Hidalgo, Texas to a terminus in the New York/New Jersey area on the Eastern seaboard. Texas Eastern is one of the largest pipelines serving the Northeastern U.S. gas markets, and has served these markets since its formation in 1947.

Most of Texas Eastern's gas pipeline business involves the purchase and sale for resale of natural gas to predominantly residential and commerical markets served directly by its distribution company customers, or indirectly through the respective systems of its interstate pipeline customers. For example, it is practically the sole supplier of Algonquin Gas Transmission Corporation, and hence indirectly a major supplier of gas to New England markets.

Its integrated system links diverse supply sources with these markets, its historical supply base having been in the Gulf Coast area. Through connections with other pipelines it also imports Canadian gas supplies. While most of Texas Eastern's gas supplies are purchased from independent producers, it also has a strong supply base with its pipeline suppliers. Because of a successful gas purchasing strategy emphasizing the negotiation of market responsive contracts with its various suppliers, Texas Eastern has the lowest cost gas supply serving its market, for which it competes with several other major interstate pipeline companies.

Texas Eastern also provides transportation services to shippers and has done so for many years. Initially these shippers were other pipeline companies and local distribution companies on whose behalf Texas Eastern transported gas pursuant to certificates of public convenience and necessity issued under Section 7 of the Natural Gas Act. With the advent of Section 311 of the NGPA and the Commission's expedited Section 7 blanket certificate program instituted in 1979, Texas Eastern has increasingly transported gas for all shippers under these expedited and self-implementing authorities. The volume of gas transported under all such programs has been considerable. For example, during the 12 months ending October 31, 1985, Texas Eastern transported a total of approximately 128 billion cubic feet of interruptible gas for its customers and for third party shippers. This compares with total sales by the pipeline of approximately 838 billion cubic feet during the same period.

Texas Eastern was one of the first major pipelines to propose and receive approval to provide open access blanket transportation under flexible transportation rates prior to the issuance of Order No. 436. Since September 1, 1985, all blanket transportation on Texas Eastern's system has been provided under its innovative flexible transportation rate (TS-3), which was placed into effect on September 1, 1985, as part of a general rate decrease filing made effective on that date. These transportation rates have proven to be market responsive.

The principal purpose of this statement is to address Texas Eastern's concerns about FERC Order No. 436. We emphasize to this subcommittee that Texas Eastern is prepared to continue to voluntarily transport gas on an "open access" basis for all shippers under Section 311 and the Section 7 blanket certificate authority of Order No. 436 provided that reasonable operational and rate requirements are met. By open access, we mean the transportation of gas under these particular programs for all shippers on a basis that is not unduly discriminatory. However, Texas Eastern cannot and will not accept the onerous condition under Order 436 that would permit our resale customers to unilaterally abrogate contracts with Texas Eastern in the event such voluntary transportation is undertaken.

Since November 1, 1985, the effective date of Order No. 436, Texas Eastern has, at the request of its customers, provided Section 311 transportation for substantial quantities of gas on an open access basis. Texas Eastern would be prepared to continue to offer open access to all shippers under Section 311 after February 15, 1986 and, as well, under the Section 7 blanket certificate authority after December 15, 1985, were it not for the onerous and unjustified contract abrogation conditions that FERC has imposed on such open access after those dates.

By providing pipeline customers the new unilateral right to reduce or convert sales contracts (hereafter referred to as "reduction/conversion condition") as a consequence or condition of open access transportation under Order 436, we believe the Commission is impeding, and not fostering, open access transportation. This condition is unwarranted for at least the following reasons:

1. The condition destroys the contractual balance between supply and demand under which a pipeline must operate to satisfy the long-term supply requirements of its customers. This directly jeopardizes the past commitments that are now in place. In addition, Texas Eastern cannot plan and implement a supply program to meet future long-term certificate obligations without firm or ascertainable customer purchase commitments under long-term contracts. In its zeal to support the access of gas consumers to spot market supplies under Order No. 436, the Commis-

sion has threatened the long-term supply arrangements that a pipeline prudently must undertake to meet its Natural Gas Act obligations. Authoritative studies show an alarming reduction of our nation's natural gas reserves although the nation is currently experiencing a short-term deliverability surplus. The contract reduction/ conversion condition of Order No. 436 will exacerbate this problem by discouraging interstate pipelines from developing long term supplies at the lowest reasonable cost. This deemphasis of long-term contractual commitments will eliminate much of the incentive for producers to search for new gas reserves.

2. The condition is also unnecessary. It impacts and relates solely to sales contracts that are independent of, and relate to a separate service from the targeted transportation function. Order No. 436, by imposing an open access requirement under all self-implementing and blanket transportation programs, has directly and completely responded to any concerns that could be inferred from the Maryland Peoples' Counsel decision of the U.S. Court of Appeals for the D.C. Circuit. The Commission addressed the

discrimination issue discussed in that case more than adequately by providing for interruptible transportation on behalf of end-user shippers and local distribution company shippers on an equal basis. The court's opinion neither required nor dealt with any need for reduction of a pipeline's resale contracts. The adjustment of sales contracts to current market conditions should be achieved through bilateral contract negotiations between pipelines and their customers.

3. In Texas Eastern's opinion, the contract reduction/conversion condition of the order as specifically imposed upon Section 311 transportation is counter to Congress' intent in enacting that section of the NGPA. The Commission has erroneously claimed in Order No. 436 that the intent of Congress was to grant it full and unrestricted conditioning authority on Section 311 transportation. It thus believes that it has the authority to impose conditions that impede the type of transportation under this section which Texas Eastern believes the Congress intended to encourage.

4. The open ended nature of the reduction/conversion rights of Order No. 436 will upset a pipeline's

complex balancing of producer, pipeline, and import purchases with market demand, and directly threatens to greatly increase take-or-pay exposure by a pipeline to its suppliers under existing contractual commitments.

5. By promoting the abrogation of existing contracts, the contract reduction/conversion condition also revokes certificated sales rights and obligations upon which the pipelines were financed and built. In this connection, Texas Eastern does not support any effort to abrogate contracts through legislative or administrative action, whether these contracts be with its customers or with its producer suppliers. Thus, Texas Eastern does not advocate the mandatory abrogation, renegotiation, or termination of producer contracts as a "cure" for the contract reduction/conversion condition that FERC has imposed. Instead, Texas Eastern submits that the condition should be eliminated and open access transportation should be permitted under Section 311 and the blanket rules on a basis that preserves gas industry contractual relationships.

Through its efforts in the courts and before the Commission, Texas Eastern is encouraging the removal of the contract reduction/conversion feature from Order No. 436. Texas Eastern is willing to renegotiate service agreements with its customers which provide an acceptable schedule for contract reductions, if desired. It urges the Senate to take action to remove the contract reduction/conversion feature from the open-access scheme of Order No. 436, and supports Senate Resolution 255 in its efforts to permit a meaningful and voluntary natural gas transportation program.

Texas Eastern thanks the Chairman and this Subcommittee for the opportunity to submit this statement.

INGAA

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December 5, 1985

The Honorable Don Nickles, Chairman
Subcommittee on Energy Regulation
and Conservation
Senate Committee on Energy and
Natural Resources
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of the interstate pipelines, I appreciated your interest and comments during the Senate Energy Regulation and Conservation Subcommittee hearing on FERC Order 436 on November 21.

It was evident from your questions of the various witnesses that you grasp the importance of the relationships between FERC's Order 436 and the pipelines' continuing service obligations to their customers and why many pipelines have such severe problems with the FERC's new rule.

I would like by this letter to expand further upon the concerns expressed by the pipelines regarding this matter, lest there be any lingering questions in your mind.

Under long-standing firm sales service agreements with their local distribution company (LDC) customers, pipelines are typically obligated to provide them, upon demand, specified maximum and average daily quantities of gas, and to maintain reserves of gas and pipeline capacity to enable them to do this. Under Order 436, a pipeline opting to be an open access transporter must offer an LDC customer two means for replacing a pipeline's gas with other gas supplies -- via firm transportation service from the pipeline and via interruptible transportation service from the pipeline. The pipelines' fears of becoming backup suppliers, or suppliers of last resort, arise from the ability of LDCs to obtain interruptible transportation from the pipelines, without reducing their contract demand or the pipelines' continuing obligation to provide firm service on demand. This is really the more serious of the two problems posed by Part IV.A of Order 436. Let me explain.

Because of recent FERC regulatory changes, most LDCs no longer are required to pay a minimum bill for gas from the pipeline. Thus an LDC, under the order, could simply substitute spot market gas for pipeline supply in whatever amounts it chooses, whenever it is advantageous for it to do so. Because the pipeline obviously has developed the capacity to serve the LDC, the LDC would face little likelihood that the interruptible service would in fact be interrupted for capacity reasons. On the other hand, the pipeline's full sales obligation to the LDC would remain intact,

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so that if transportation is interrupted or spot gas falls short of meeting its needs, the LDC could simply swing back to the pipeline's system supply. Mr. Terpstra testified that MidCon's customers have already stated that they fully intend to swing back to the pipeline on peak days when spot gas could be in short supply. In this situation, the pipeline would experience the worst of both worlds: existing reserves, bought to supply the LDC, being turned back when the LDC could find cheaper gas, and yet a continuing obligation to live up to full contract requirements whenever the LDC wants to swing back.

It is true that the LDC would have to pay the pipeline a demand charge based on the full service sales agreements. In many circumstances this is a relatively small price to pay for the right to have assured pipeline gas available in case spot gas fails. Indeed, Mr. Schroer, President of Northern Indiana Public Service Gas Co., who appeared on the third panel on behalf of AGA, indicated that this would be the logical course of action for his company. The demand charge, however, provides scant protection for the pipeline against the reduction of purchases from its suppliers and the consequent added exposure to take-or-pay liabilities. As was pointed out at the hearing, these sums could be enormous.

If the LDC chooses to reduce or to convert a part of the pipeline's sales service to a firm transportation service, the "25% rule" applies, and indeed the pipeline's service obligation to that customer is reduced accordingly. This is the situation Mr. Legato was addressing in response to Senator Bradley's questions. Mr. Legato failed to note, however, that there is no corresponding relief at the supply end where the pipeline is bound to continue its contract purchase obligation to the producer. This is a major concern to the pipelines, of course, because of the exposure to greater take-or-pay liability.

As Senator Bradley observed at the hearing, pipelines participating in the transportation program would be "whipsawed" between both ends of the pipeline. The seriousness of the situation and the potential impact on pipelines is the basis for the interstate pipelines' concerns. Since the producer, under the Commission's rule, would have open access to transportation, the pipeline would have nothing to trade with the producer in return for offsetting take-or-pay commitments.

As you know, INGAA is doubtful that the Commission will act on rehearing to recast Order 436 in a way to resolve this and other problems with the order. Because transportation is an important and growing part of our business, we have decided to support, even advocate, open non-discriminatory access legislation, assuming that a reasonably balanced bill can be put together.

We look forward to working with you and your committee in fashioning such legislation. I would respectfully request that this letter be made a part of the hearing record on FERC Order 436.

Sincerely,

Jerome McGrath

Jerome J. McGrath
President

INGAA

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December 11, 1985

Honorable Don Nickles, Chairman
Subcommittee on Energy Regulation
and Conservation
Committee on Energy and Natural Resources
U. S. Senate
Washington, D. C. 20510

Dear Mr. Chairman:

During the Subcommittee's hearing November 21 on Federal Energy Regulatory Commission Order No. 436, there were several misstatements and blatant errors in the testimony of the witness Carmen Legato and incorrect assertions in the statement of the witness David Hentschel, which I am compelled to call to your attention. INGAA desires to set the record straight on these matters and respectfully requests that this letter response be made a part of the hearing record.

In his testimony, Mr. Legato made numerous unsupported allegations concerning interstate pipelines, but I would like to focus on four specific points he made which cannot stand unchallenged.

1. Legato (Tr. 127-128)

> "First of all, they say that they would become the backup supplier. They would have a continuing obligation to sell gas to these distribution companies who then could swing on and off of the system. That is patently untrue.
>
> "The FERC provided that, to the extent the distribution company exercises the option to convert the firm delivery service so that they can buy gas from someone else instead of the pipeline, that that automatically terminates any obligation on the part of the pipeline company -- automatically, by force of law, terminates any obligation on the part of the pipeline company to sell gas in the future to that distribution company."

Response -- Mr. Legato's statement is misleading and in error. The pipeline witnesses testified that their major concern was the ability of local distribution companies (LDC) to request interruptible transportation of spot gas purchased by the LDC in replacement of pipeline system supply but without changing in any way the LDC's contract demand or the pipeline's continuing service obligation to render firm uninterruptible service whenever the LDC demanded it. Order 436 enables, indeed, encourages the LDC to do this, making the pipeline the backup supplier or the supplier of last resort. Mr. Legato was referring to the right of LDCs to convert firm contract demand to transportation service, a totally different situation. See also my letter to you dated December 5, 1985.

2. Legato (Tr. 128)

> "Point number two, they claim that this constitutes contract abrogation at the distribution end, and that therefore it's unbalanced because they're still liable under contracts with producers. Again, not true. All of the pipeline companies raised that issue in the United States Court of Appeals for the District of Columbia Circuit in the Wisconsin Gas case, and on August 20th, 1985, that court said that the pipelines' contention that this amounted to contract abrogation did not warrant textual discussion.
>
> "In a footnote, they said: 'This claim is frivolous.' So much for the contract abrogation argument."

Response -- Mr. Legato's quotation from the court is inapposite and his assertions misperceive the pipelines' contention. The court was there referring to the petitioners' claim in that case, that the Commission's Order 380 (on minimum bills) "unlawfully alters the terms of existing contracts by destroying the mutuality of obligations between the pipeline and the partial requirements customer." What the pipelines are contending with respect to Order 436 is that the Commission felt free to override the contractual relationship between the pipeline and its customers by allowing the unilateral reduction of the customers' contract demand but made no corresponding adjustment in the pipeline's take-or-pay obligation in its contract with the producer-supplier. This issue was not before the court in the minimum bill case, and it is unfair and untrue to assert it was.

The gravity of the take-or-pay problem is perhaps best expressed by the Commission itself where it stated "...take-or-pay is an overarching impediment in the movement toward a more competitive market, and more specifically to broader pipeline transportation programs." See FERC Petition For Rehearing and Suggestion For Rehearing *en banc*, dated June 24, 1985 *Maryland People's Counsel v. FERC*, U.S. Court of Appeals for the District of Columbia Circuit, No. 84-1019, p.8. Unfortunately, the Commission, in Order 436, paid little heed to its own warning.

3. Legato (Tr. 128)

> "The third point is that they will be faced with these enormous take-or-pay liabilities. Again, not true. The take-or-pay liability doesn't exist in their statistics for all the gas -- the full purchase price of the gas. When they back off on takes from the major oil companies who are trying to seek a preserve on that local distribution company market that the independents want into, what will happen is they will cut back the major producers, and the major producers will sell their gas at a lower price to someone else.

> "The only contract obligation they have is to pay the difference between the market price for the gas and the contract price -- not these billions of dollars that they claim."

Response -- Again, Mr. Legato trifles with the facts. While there may be some producer contracts which specifically allow the producer to collect from the pipeline only the difference between the contact price for gas not taken and the "market price", i.e. the price received by the producer by selling it to a third party, the vast majority of contracts, so far as we know, do not include such a provision. Although it is impossible to categorize every variation of take-or-pay provision that exists, I have enclosed two typical take-or-pay provisions published by Federal Programs Advisory Service. Neither clause contains the provisions claimed by Mr. Legato.

4. Legato (Tr. 129)

> "Another point. They contend that shareholders will take it on the chin if they have to settle these take-or-pay claims with producers. Again, untrue. Read the FERC rule that says we will allow them to pass through, dollar-for-dollar, any prudently incurred expense in connection with the buyout or settlement of a contract dispute with a producer."

Response -- Once again, Mr. Legato misses the point. While take-or-pay costs may be passed through under the case-by-case procedure prescribed by the Commission, the fact of the matter is the market will not absorb the increase in rates to consumers that would result. Mr. Legato, himself, alluded to the problem facing the pipelines and their customers earlier in his diatribe when he noted that pass through of such costs is "...having the undesirable effect of causing consumers to invest millions of dollars in electric heat pumps, and wood burning stoves, and causing power plants not to convert to gas." (Tr. 129). This reflects exactly a major concern of the pipelines. Clearly, as Senator Bradley noted -- the pipelines are being whip-sawed by Order 436. Mr. Legato's wild claims to the contrary notwithstanding, pipelines are being severely hamstrung in their efforts to meet competition.

Mr. Hentschel in his testimony (Tr. 19-20) referred to a study undertaken by the Natural Gas Supply Association on pipeline rates of return and pipeline margins, apparently concluding that both are high. The study, an executive summary of which was included with Mr. Hentschel's written statement and is a part of the record in this hearing, is in error. The NGSA analysis claims that pipeline margins in 1984 were $1.64 per Mcf. The fact is, pipeline margins are considerably less than the amount alleged by NGSA -- $1.08 as compared to $1.64.

The major error in NGSA's study involves double counting of pipeline revenues in national aggregate figures. In pipeline-to-pipeline sales, the report counts the transmission charges of the upstream pipeline once from the upstream pipeline's Form 2 and a second time from the downstream pipeline's Form 2 (where it appears as a payment to the upstream pipeline). It is as if someone studying the candy bar industry observed that the wholesaler charges 50 cents and the retailer charges $1.00 and then concluded that the customer pays $1.50.

EIA provides all the data for 1984 necessary to calculate pipeline margins on gas sales. The enclosed calculation sheet shows that in 1984, the interstate pipelines' margins averaged $1.08 per Mcf not $1.64.

With respect to the rate of return figures included in the NGSA report, the methodology is not described in adequate detail for us to reproduce the numbers generated. However, it is worth noting that NGSA's consultants advised NGSA that "it is virtually impossible for any pipeline's actual rate of return on rate base or common equity to precisely mirror its FERC authorized rate of return. The reason is that rate regulation is prospective, and thus necessarily always based on estimates of the future...[and] the future is uncertain and unknown. This fact of life is particularly important during the period of 1977-1984 because of the unprecedented rise and fall of inflation, volatility in interest rates, and general uncertainty in the economy, especially in the gas industry." (Supplemental Analysis, pp. 1-2, emphasis added.)

Finally, Mr. Chairman, Mr. Legato and other witnesses at the hearing complained that consumers, i.e. LDCs and end-users, lack access to competitively priced gas because pipelines have refused to transport gas for others, especially LDCs. This is not true. As we pointed out in our written statement, transportation of natural gas for LDCs and end-users has been growing significantly. Since 1982, the first year INGAA began to compile such data, such transportation has increased from 360 Bcf in that year to more than 1319 Bcf in just the first three quarters of 1985. Third quarter 1985 transportation increased 93 percent over the same period last year (530 vs. 274 Bcf) and accounted for 22 percent of all gas delivered in interstate markets. In 1982 such transportation accounted for only 3 percent of gas delivered in interstate markets. INGAA has every reason to believe that had not the court's decisions in the Maryland People's Counsel cases (Mr. Legato's client) and FERC Order 436 intervened, this trend in transportation of gas for others would have continued and expanded. Because of the major impediments imposed by Order 436 uncertainty and confusion abound.

It is our hope that legislation can be enacted that would provide for open non-discriminatory access to transportation in a manner fairly balancing the interests of consumers, distributors, producers and transporters of natural gas.

Yours truly,

Jerome McGrath

Jerome J. McGrath
President

Enclosures

cc: Members, Subcommittee on Energy Regulation and Conservation

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December 16, 1985

Honorable Don Nickles, Chairman
Subcommittee on Energy Regulation
and Conservation
Committee on Energy and Natural Resources
U. S. Senate
Washington, D. C. 20510

Dear Mr. Chairman:

Through inadvertence the enclosed attachments to my letter of December 11, 1985, concerning the Subcommittee's hearings on the Federal Energy Regulatory Commission's Order No. 436 were not included.

Copies of the attachments are forwarded herewith, and I respectfully request that they be included with my letter as part of the hearing record.

I apologize for any inconvenience this may have caused.

Yours truly,

Jerome J. McGrath
President

JJM:bsg

Enclosures

cc: Members, Subcommittee on Energy
Regulation and Conservation

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¶54.030 TAKE-OR-PAY

With the fixed costs of gas production and delivery facilities, many contracts include a take-or-pay clause that requires the Buyer to take a certain minimum daily quantity or pay for that same quantity if it is made available, but is not taken. Take-or-pay reduces a Buyer's ability to respond to market conditions, and therefore is coupled with make-up clauses (see ¶54.032, below) for the Buyer's protection.

Note that additional take-or-pay provisions often are included in clauses addressing Buyer's commitment to install new equipment. See Section 53, Commitments and Reservations, ¶53.006, for discussion of these additional take-or-pay provisions.

Because of the effect on a Buyer's market response flexibility, take-or-pay figured prominently in the legislative and FERC efforts to resolve the gas market problems that arose in 1982 and 1983. In December 1982, FERC adopted a policy against take-or-pay levels above 75 per cent of delivery capacity in new interstate pipeline purchase contracts. Docket No. PL 83-1, 47 Fed. Reg. 57268, Dec. 23, 1982. Moreover, the take-or-pay clause was one of the most controversial issues in the legislative debate over gas regulation during the 98th Congress. Statutory ceilings on take-or-pay levels, such as 50 per cent or lower, were included in bills considered by both the Senate and House.

One issue of increasing significance involves the relation between the pipeline's contractual take-or-pay obligation and its regulatory exposure with state ratable take laws. In some states, pipelines have been able to guide their ratable take obligation through the procedure of nominating takes, upon which the state conservation agency then sets allowable takes for the year. As explained below, Clause B gives the pipeline purchaser credit for take reductions due to state ordered allowables under ratable take regulations. Accordingly, producers and their attorneys should consider carefully whether credit for deficiencies due to state ordered allowables might reduce the take-or-pay obligation to an unacceptably low level. This will depend in part upon the nominating procedure in the state in which the gas is produced.

Take-or-pay is usually a complex clause, entailing correlative provisions dealing with make-up and repayment. The length and complexity of the take-or-pay clause reflect the difficult and competing economic interests being reconciled therein.

Clause A

> In the event that Buyer fails to take the quantities of gas Buyer was obligated to take or pay for during any Contract Year in accordance with this Article, Buyer shall make payments to Seller, within [ ] days after the end of such Contract Year in which the deficiency occurred, for a quantity of gas equal to the difference between the total quantities Buyer was obligated to purchase or pay for during such Contract Year and the total quantities actually taken and paid for during such Contract Year.

Clause A provides the basic operative language for take-or-pay; the Buyer pays for gas it is obligated to take but has not taken. The Buyer's obligation to pay for this gas not taken is determined on an annual basis, which is the normal take-or-pay accounting period. Clause A, however, does not specify the price at which this take-or-pay liability is incurred (i.e. price at time of tender; weighted average contract price during the year; or price at the end of the Contract Year). This omission can lead to confusion.

Clause B

> If, at the end of any Accounting Period, Buyer shall have failed to receive during such year the applicable Daily Contract Quantity, after credit is allowed by Buyer for (i) deficiency existing by Force Majeure, (ii) default of Seller and failure of Seller to deliver gas in quantities as and

> when requested in accordance with the provisions hereof, and (iii) the total of the difference between Seller's Allowable for the wells covered hereby, and the Daily Contract Quantity, if the Allowable is less than the Daily Contract Quantity on any day or days during such Accounting Period. Buyer shall pay for the remaining deficiencies as if taken. Payment for such gas shall be made by Buyer to Seller within [ ] days next succeeding the close of the Accounting Period at the weighted average price in effect during the Accounting Period in which the deficiency arose, determined on the basis of the volumes actually sold at the price or prices paid during any such period.

Clause B is more complex than Clause A. It explicitly credits the Buyer for deficiencies in takes due to force majeure, Seller default, and state ordered allowables, before computing (reducing) deficiencies for which payment must be made. It also states with precision the method for pricing take-or-pay gas. If a clause such as Clause B is used, the term "Accounting Period" should be defined (see Chapter III, Contract Provisions of General Applicability, Section 22, ¶22.008, for sample definition).

¶54.031 Commencement. Normally, take-or-pay is determined on a contract year or other periodic basis, with commencement tied to initial deliveries under the contract; thus, there is not a separate take-or-pay commencement clause. In the specific situation where the Buyer is responsible for constructing and operating new gathering facilities to connect the wells under contract, however, certain conditions on commencement may be appropriate.

Clause A

> On [a specific date], Buyer shall commence its annual obligation to take or pay for gas from any well completed and qualifying for connection hereunder prior to [one month prior to the date specified], provided Buyer has received and accepted all necessary right-of-way permits and governmental authorizations necessary to commence the purchase and sale of the gas. In the event the necessary right-of-way permits have not been received and accepted by Buyer on [the date specified], the date of commencement of take or pay shall become effective the first day of the month following the date such permits and authorizations are received and accepted by Buyer.

Clause A appears to trigger take-or-pay when the wells qualify for connection, whether or not the Buyer has completed the gathering facilities. It does protect the Buyer, however, from take-or-pay liability if the Buyer cannot take delivery due to lack of governmental authorizations. While the Buyer's correlative obligation to use due diligence in seeking such authorization probably is implicit, an explicit clause to that effect also may be included. The Preliminary Acts Article, Section 52, ¶52.020, above, this Chapter, frequently includes a regulatory filing clause that would suffice. A general Government Regulation Article, such as the one in Chapter III, Section 23, also would impose this responsibility.

The clause addressing Buyer's commitment to install equipment often contains take-or-pay provisions in addition to the take-or-pay clauses in the Quantity Article. See Section 53, Commitments and Reservations, ¶53.006, for samples of these clauses.

¶54.032 PREPAID GAS

Instead of invoking take-or-pay liability, the parties could agree to use an initial prepayment clause until deliveries commence, with a different type of make-up and a guaranteed repayment. Should a contract contain provision for "initial prepaid gas" (gas paid for prior to first deliveries under the contract), make-up by the purchaser is invariably guaranteed. Guaranteed make-up is accomplished in various ways: (1) initial prepaid gas is agreed to be the first gas delivered; (2) daily contract quantities (DCQ's) are temporarily modified to allow ease of recoupment by the purchaser or (3) guaranteed repayment, either in volume or dollars, is generally stipulated by the parties, irrespective of take-or-pay repayment provisions.

[**¶54.033** and **¶54.034** are reserved.]

[The next page is p. 59.]

COMPUTING INTERSTATE PIPELINE MARGINS

Pipeline Net Margin = $\frac{\text{Sales Revenues - Outlays for Gas Supplies}}{\text{Sales Volumes}}$

Sales Volume = 10.1 Tcf[1]

Sales Revenues = Sales Price[2] x Sales Volumes

= $4.05/Mcf x 10.1 Tcf = $40.9 billion

Outlays = Price from Domestic Producers[3] x Volume from Domestic Producers[4] + Price for Imports[5] x Import Volume[6]

= $2.91/Mcf x 9.2 Tcf + $4.08/Mcf x 0.8 Tcf
= $30.0 billion

Pipeline Net Margin = $\frac{\text{\$40.9 billion - \$30.0 billion}}{\text{10.1 Tcf}}$
= $1.08/Mcf

1/ EIA, Natural Gas Monthly, Table 13, August 1985, published October 1985. Note: Sales exclude double-counting of pipeline-to-pipeline sales, see p. 68.

2/ Ibid., Table 13.

3/ Ibid., Table 4.

4/ Ibid., Table 15.

5/ Ibid., Table 4.

6/ Ibid., Table 15.

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ROBERT M. ZINKE
DAVID B. TRUMBO

November 25, 1985

Honorable Senator
Don Nickles
United States Senate
Washington, D.C. 20510

RE: FERC Order No. 436

Dear Senator Nickles:

By way of introduction, I am the Chairman of the Board and Secretary of a small independent oil and gas company incorporated in the State of Oklahoma. I formed my company, Zinke & Trumbo, Ltd., with my partner, David B. Trumbo, in October of 1980. David and I literally formed our company on our dining room tables with very little capitalization. Through sheer hard work and persistance, we built Zinke & Trumbo, Ltd. into a very successful and active Oklahoma oil and gas exploration company that directly employs eleven individuals, drills approximately twenty wells annually, and pays a substantial amount of money into the tax coffers of the State of Oklahoma. I would also like to point out that all this was accomplished during a time when our industry was experiencing one of the most severe recessions in its history.

David and I are quite proud of our company's accomplishments however, we realize that the "road to hoe" is still ahead of us and fraught with many adversities. Currently, the most significant of these hardships is the continuing price deterioration of the commodity products we sell - oil and natural gas. This brings me to the point of my letter - which is, it is difficult enough to survive in today's oil and gas exploration business environment without having to deal with artifically introduced hardships created by our Federal government. Specifically, I am referring to the purported tax reform movement currently being considered in Congress and the "legislation" coming from the apparent new "Super Legislative" body - the FERC.

In this letter, I want to specifically address FERC Order No. 436 which was issued as a Final Rule on October 9, 1985, pursuant to RM 85-1-000 and the impact that its implementation has had on small gas producers like Zinke & Trumbo, Ltd.. its employees, its bankers and the State of Oklahoma. Although it is clear that the intent of the FERC in promulgating this order was to

OIL AND GAS EXPLORATION AND PRODUCTION

adapt the regulatory order of things towards the significant changes that have taken place in the natural gas industry since the NGPA 1978 and to live up to its statutory responsibility under Section 4(c) of the NGA-1938 (which requires that all gas rates and practices subject to the jurisdiction of the Commission shall be "just and reasonable"), FERC Order No. 436 totally misses the mark in several crucial areas. Those areas are reflected in the fact that FERC Order No. 436 never anticipated the arrogance most interstate pipeline companies would exhibit by keeping their systems closed and the resulting hardships their attitude would work on independent producers, their employees, their bankers and their respective state governments.

According to testimony given before you in a recent hearing on November 1, 1985, somewhere between 400 to 600 MMCFGPD was shut in within the State of Oklahoma and continues not to be moved or sold. This is a substantial amount of natural gas and quite obviously represents a problem of enormous proportion to producers, their supporting financial institutions, and the State of Oklahoma. This situation is purely a result of the impotence of FERC Order No. 436 and the arrogance of the interstate pipeline companies who refuse to open their systems. I fear if some legislative pressure is not administered immediately, many of the interstate pipeline companies will continue to refuse access to their systems for possibly another twelve to eighteen months. The result of that distinct possibility would obviously result in total devastation to Oklahoma's natural gas producers and financial institutions. When I recently hypothesized this scenario to Mr. Chris Warner, Associate General Counsel for the FERC, I received an uncompassionate shrug and a brief dissertation about the "rocky road" ahead for the nation's producers as the FERC brings the regulation of the natural gas industry in line with the concept of market responsiveness. To be quite honest with you, Senator, it has been my experience that a shrug and a brief explanation involving tough times does very little for my banker and goes nowhere with Federal bank examiners. I do not specifically blame Mr. Warner for his reaction and lack of understanding. I suspect it is more reflective of the overall sense of things in Washington today - that is -- "Bob, you are a very small cog in the larger scheme of things and quite frankly we don't give a damn about you, your company, your employees and particularly your state". My reaction to that is quite simple - fine, but when you start squashing the small, highly motivated and productive individuals within our system, you are tearing at the very fiber of this country's socio-economic infrastructure. And besides that, I feel that the results of FERC Order No. 436 are and will continue to be so onerous to the producer, especially the small independent producer, that there is absolutely no fathomable way that the resulting practices could be considered "just and reasonable" under Section 4(c) of the NGA.

In light of my remarks, I am compelled to request that you use all your influence and power in the Senate to bring the interstate pipeline companies to the immediate and full realization that they have finally and completely lost their middleman, merchant role. They must immediately be made to realize that their new future role in the natural gas industry is that of non-discriminatory transporters. I fear if this is not accomplished in the legislature before year end, we will be in a "starring" contest between the FERC and the "hold-out" interstate pipeline companies with the only loser being the small independent producers who did not have the financial where-with-all to stay for the fight.

One other failure of Order No. 436 that will prove to be of monstrous proportion in the future will be the total lack of address to the question of supply. How soon we forget - the winter of 1977. Quite frankly, natural gas is fast falling into the line of commodity treatment. That is well and fine but historically, commodity supply and demand cycles have proven to have cruel swings. The absolute non-recognition of this fact once again represents Washington's "band-aid", short term approach to problem solving that in the long term will be extremely detrimental and costly to gas consumers and the economic and costly military security of this nation. I am certain that history will relegate FERC Order No. 436 to a companion level of stupidity with the Fuel Use Act-1977.

As a matter of constructive suggestion, I feel two actions should be taken immediately by you and your staff to assist your constituency with the fallout of FERC Order No. 436. As a short term approach, I feel you should demand that the FERC grant a six month to one year extension on their October 9, 1985. effective date of implementation. This would allow for all facets of the industry to more effectively and comfortably prepare for this transition into the new era. On a long term basis. I suggest that you demand the FERC revise Order 436 to provide for meaningful incentives for the interstate pipeline companies to accept their new transportation role. In this regard, I feel any vehicles allowing for contract abrogation on either end of the pipeline are out of the question and dangerously unconstitutional. Finally, I feel that the natural gas industry must be deregulated.

I am confident that you and the other members of the Oklahoma legislative delegation will not allow this state's small independent producer to be steam rolled into the backwater of economic dispair and ruin by the interstate pipelines companies arrogance and the Washington bureaucracy's indifference. I sincerely hope that you personally will be afforded the opportunity to read this letter. I have done my best to communicate to you, as accurately as possible, a very desparate situation that currently exists in your home state. If immediate and effective legislative action is not taken, I fear Oklahoma's economy will suffer a blow from which it will never be able to recover.

Sincerely yours,

Robert M. Zinke

cj
cc: L. Dow Davis IV

J Donald Annett
Vice President

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November 22, 1985

The Honorable Don Nickles
Chairman, Subcommittee on Energy
Regulation and Conservation
Senate Committee on Energy and
Natural Resources
Washington, D.C. 20510

Dear Senator Nickles:

On November 21, 1985, your Subcommittee held hearings on the regulations recently issued by the Federal Energy Regulatory Commission requiring non-discriminatory transportation by interstate pipelines, and on the Commission's accompanying proposal to require pipelines to bill for gas in two segments rather than on a rolled-in, average basis -- the so-called "block billing" proposal. As you know, the Commission has delayed implementation of the block billing program until next summer, and has asked for a second round of comments on the plan, particularly with regard to its effects on the nation's gas supply.

Texaco has supported freer access to transportation on interstate pipelines, but is very concerned about the effects of the block billing program on the gas industry and, ultimately, the national economy. Texaco has accordingly submitted Supplemental Comments in response to the Commission's request for additional comments on block billing, a copy of which is enclosed. We respectfully request that they be included in the official record of your Subcommittee's hearings on this matter. An Executive Summary appears on pages ii to v.

We present in our Supplemental Comments (1) important new economic analysis of the gas market, demonstrating the effects and relative merits of the various policy elections; (2) an update of our previous estimates as to the adverse effects of block billing on producer revenue; and (3) our recommended phased approach to achieving a rationalized, more competitive gas industry if the Commission adopts the block billing concept.

In Part I of our comments, we present a new qualitative economic analysis of block billing and its effects on the gas industry by Professor George Horwich of Purdue University. Professor Horwich's analysis clearly demonstrates the following points:

1. A natural gas market in which no gas is subjected to artificially imposed price ceilings maximizes

social welfare for both consumers and producers, and hence for the nation as a whole.

2. Contrawise, the imposition of price controls on even a portion of the gas supply decreases net social welfare for both producers and consumers.

3. Rolled-in pricing, combined with price controls on a portion of the gas supply, promotes a certain amount of wasteful consumption.

4. However, a) that amount of wasteful consumption is not large; b) misallocation of price-controlled (old) gas under historical use allocation as contemplated in the block billing proposal could create inefficiencies of consumption which would more than offset any consumption efficiency gains of block billing; and c) in any event, block billing will impose on producers severe revenue losses that could seriously discourage exploration and drilling for new gas supplies.

5. A phased-in approach to raising the ceiling on old gas prices, even if combined with block billing, promises to yield substantial benefits to both producers and consumers of natural gas and to increase net social welfare.

Professor Horwich also critiques the Commission's theoretical defense of block billing contained in its Notice and finds such fundamentally flawed.

In a previous filing with the Commission, Texaco attempted to quantify the potential losses which could be suffered by producers if block billing is imposed. Texaco has updated this study in Part II of the Supplemental Comments and we conclude that producer losses could be in excess of $18 billion by 1990. The study itself is attached as Exhibit A to the comments.

In Part II of our comments we also review our recommendation that, in the event the Commission determines to proceed with imposition of block billing, it should and must take simultaneous action, within its clear legal authority, to increase old gas prices to more market responsive, just and reasonable rates in such a manner as to achieve substantial revenue neutrality for producers and consumers. Such action would have the benefits of (1) removing a major legal flaw from the present block billing proposal (i.e., discriminatory treatment of producers in contravention of the NGPA);

(2) permitting all gas to move towards being sold as a commodity at appropriate market levels, eliminating the economic distortions of price controls and rolled-in pricing; and (3) avoiding a major reduction in producer funds available for future exploration. An evaluation of revenue effects of such a combined approach is also included in Exhibit A.

Thank you for your attention to our concerns.

Respectfully,

J Donald Arnett

cc: Members of Subcommittee (with Executive
Summaries only)

BLOCK PRICING OF NATURAL GAS AND THE FUTURE OF U.S. ENERGY SUPPLY

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Executive Summary

The Federal Energy Regulatory Commission has proposed that the practice by interstate pipelines of averaging or "rolling in" the prices of the various vintages of natural gas be ended. Instead, pipelines would be required to bill each vintage of gas separately in two major billing categories or blocks: block 1 for "old" controlled gas, block 2 for "new" uncontrolled gas.

The evaluation of the proposal is carried out by means of a simple model of natural gas supply and demand. The model contains separate supplies for old and new gas, each a rising function of price, and a single demand directed at the physically indistinguishable components. Social surplus, the measure of economic welfare or benefit, is the sum of consumers' surplus, which is the area beneath the demand curve and above the market price, and producers' surplus, which is the area above the supply curve and below the market price.

The method of analysis is first, in an unregulated market, to impose a price ceiling below the market equilibrium on old vintage gas. Then price averaging or "rolled-in" pricing is introduced. Then, in order, price averaging is replaced by block billing and old gas price controls are lifted. At each stage, price, quantity, and welfare effects, as measured by social surplus, are examined.

The imposition of a price ceiling below market level on old vintage gas results in a reduction in the quantity of old gas produced. The total output of gas will also fall, raising the price on new gas, which becomes the market-clearing and marginal price of all gas. In effect, an increment of new gas, which is more costly to produce, is substituted for some of the old gas, whose production cost is less.

If we balance out gains and losses of social surplus, the net effect of the ceiling price is a loss of producers' surplus owing to the contraction of old gas output and, because of the higher price of gas, a loss of consumers' surplus that exceeds gains of new producers and windfalls to the buyers of old gas. Both consumers and producers are worse off.

In a longer time frame, the loss to gas producers owing to the price ceiling promises to generate a diminished level of exploration and production and still greater producer losses as the supply schedule of natural gas shifts to the left. These losses, which would further exacerbate consumer losses, could eventually overwhelm the other direct effects occasioned by the control policy.

Meanwhile, the increased marginal price of gas, caused directly by the old gas negative supply response, will raise the cost and reduce the level of all goods and services in whose production natural gas is an input. This supply-induced loss of real GNP will raise the general level of all prices.

Under rolled-in pricing, pipelines sell gas at its average acquisition cost, averaging or "rolling in" the higher price on new gas with the lower controlled price on old gas. Consumers, facing the average price, are subsidized in their purchases of new gas and hence demand more gas than they would at the true marginal cost of gas, the uncontrolled new vintage price.

Greater consumption raises the price of new gas, increasing revenues of new gas producers. In effect, rents extracted from producers of old gas by the price ceiling are transferred, through price averaging, to consumers, who face a lower price, and to producers of new gas, who receive a higher price. Disincentives of exploration and drilling imposed on producers by controls on their old vintage gas are thus to some extent offset by their improved revenues on new vintage production. Consumption, however, tends to be raised above economic levels; i.e., beyond the point at which the gas is valued as much as it costs.

Block billing, as proposed by FERC, requires interstate pipelines to charge separately for each of the two major vintages of gas, essentially old and new. The effect is to remove the subsidy to demand provided by price averaging, to lower the price on new gas and the revenues of new gas producers, and to raise the price and marginal cost of gas to consumers. The net efficiency gain is the removal of uneconomic consumption. Empirical evidence indicates that this gain is small, only $500 million in the first year and declining thereafter. The gain may be wiped out, moreover, by FERC's requirement under block billing that old gas be allocated to consumers on a historical use basis. This allocation would severely inhibit the distribution of old gas to its most-valued uses. The loss of producer revenues, moreover, amounting to $1.5 billion to $5 billion per year, promises to impose serious disincentives on the exploration, drilling, and production of new gas.

The maximum gains to producers and consumers accrue under complete decontrol. Removal of the ceiling on old gas will raise production an estimated 38 trillion cubic feet by 1995. Under decontrol, the price of gas, now the same on new and old vintages and as seen both by consumers and producers, will be lower overall than in any of the controlled regimes considered. Social surplus will be maximized.

In Exhibit S, FERC justifies its block billing proposal by arguing that such pricing will not introduce any shortages to the gas market. FERC defines shortage in the technical economic sense as an excess of demand quantity over supply quantity at a price below market clearing. The present structure of the U.S. gas market, containing an uncontrolled segment, indeed permits market clearing under all circumstances. The real danger of block billing, however, is that in denying producers substantial revenues, it will depress long-run exploration and drilling and hence the absolute level of supply. The fact that supply, whether large or small, is always equal to demand is thus, in this context, of little consequence. Under reduced gas supply, demand would in fact gravitate to substitute markets, preventing the price of gas in the uncontrolled segment from rising as high as it otherwise would.

BLOCK PRICING OF NATURAL GAS AND THE FUTURE OF U.S. ENERGY SUPPLY

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The recent ruling by the Federal Energy Regulatory Commission to increase U.S. consumer and producer access to gas pipelines is a welcome move in the direction of freer and more efficient energy markets. The accompanying proposal to require the various vintages of gas to be billed separately in two major billing categories or blocks is not, however, a useful complement to that move. The present practice by pipelines of "rolling in" the prices of the various vintages of gas into a single average price is inefficient insofar as it encourages uneconomic consumption levels. But FERC's attempt to end or limit the practice by introducing block billing, while old vintage prices are not simultaneously raised or freed up, imposes inefficiencies and severe long-run costs on both consumers and producers in the natural gas industry. The costs are of a magnitude that not only promises to swamp any positive effects of block billing, but potentially to place the U.S. natural gas supply at risk in the longer-term future.

In order to show precisely the impact of block billing on natural gas prices, quantities, and on social welfare, we present a simple aggregate model of the gas market in graphical form.

The market, consisting of two supply components, an "old" supply initially produced before a certain date and a "new" supply first produced after that date, will be shown in a free unregulated state. Then, to approximate the broad essential features of the present market, a price ceiling will be imposed on the old component of production. Following this, rolled-in-pricing -- the averaging of new and old prices to consumers -- will be introduced to the model. It will then be a relatively simple task to remove, in order, rolled-in-pricing and the old gas price ceiling, observing at each stage the price, quantity, and welfare effects.

A. An Aggregate Model of the Gas Market

In figure 1, S_O^1 and S_N^1 are the prevailing supply schedules of old and new gas, respectively. Each shows the quantity (q) of a given category of gas produced per unit of time (t) as a rising function of price (p). 1/ The schedules are summed horizontally to form the total supply S_T^1. The total demand for gas, the schedule D_T^1, is directed indiscriminately at old or new gas, whose physical characteristics are assumed to be identical. In

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1/ We assume that both components of gas supply, old and new, are rising functions of price. This is a common assumption widely supported by a variety of sources. FERC's analytical defense of block billing, Exhibit S, treats old supply as completely unresponsive to price. Exhibit S makes this assumption only for analytical ease, not as an affirmation of reality. Nevertheless, as noted in our comments in section F below, Exhibit S at no time relaxes that assumption. Failing to do so deprives the FERC model of the basic source of benefits that would accrue under decontrol.

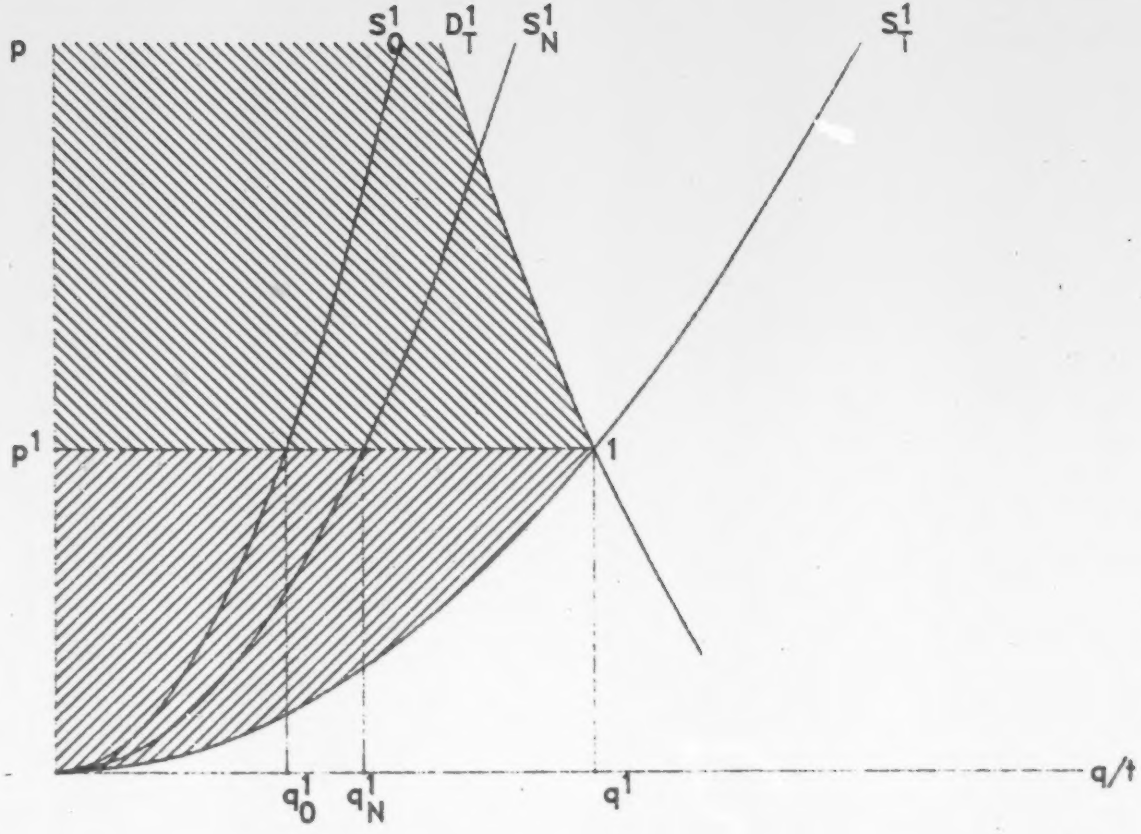

Figure 1. The market for natural gas in the absence of controls.

the absence of regulation, the intersection of S_T^1 and D_T^1 is at a price p^1 and total quantity q^1, a point designated "1" in the graph. The component quantities supplied of old and new gas, respectively, are q_O^1 and q_N^1.

The diagram is a gross simplification of the market, portraying only producers and final consumers of two vintages of natural gas. For our purposes, that is a sufficiently detailed rendering of the market. Pipelines are not explicitly shown in the graph, although their impact is reflected in various shifts of the schedules already drawn. For example, the opening of access to pipelines would tend overall to reduce costs of transmission and thus the cost of delivered gas to consumers. In figure 1, S_O, S_N, and their sum S_T would all shift downward or to the right, reflecting, at each quantity, lower shipping costs and hence, at each price, greater deliverable supply quantities. The market-clearing price, at the intersection of the new S_T schedule and D_T^1, would tend somewhat to fall and the corresponding quantity to rise.

Before imposing regulatory features on the model, we call attention to the welfare or so-called social surplus associated with the market equilibrium. The maximization of social surplus is the fundamental goal of economic policy-making. We shall therefore examine the social surplus impacts at each stage of the analysis. It will be important, however, to avoid focusing on short-run static surplus totals while ignoring specific components which, over time, may have a tendency to grow and eventually dominate the welfare outcome.

For end-users, the social or "consumers'" surplus is the excess of a good's value over its costs. The valuation of a good at any quantity is equal to the height of the demand schedule, the demand price buyers are willing to pay. The cost is the price actually paid. Since in figure 1 the price paid for all units is p_1, consumers' surplus for any given quantity is the vertical distance between the demand schedule and the horizontal line at p^1. For any given total quantity consumed, such as q^1, the total consumers' surplus is the cross-hatched area below the demand curve, above the line at price p^1, and to the right of the vertical axis (cross-hatched in blue).

Social surplus for producers, "producers'" surplus, is the difference between the price received and the cost of producing any given quantity. The height of a supply curve shows, at each quantity, the addition to total cost or the "marginal" cost as a result of producing that quantity. Producers' surplus for any given output is thus the vertical distance between the horizontal line at price p^1, which is received on all units sold, and the height of the supply schedule at that quantity. For any given total output produced, the total producers' surplus received for all units up to that total is the cross-hatched area below the line at p^1, above the supply curve, and to the right of the vertical axis (cross-hatched in green).

The example above of the gains resulting from enhanced pipeline access can be interpreted in the social surplus framework. The reader may verify that a shift to the right of the S_T schedule along D_T^1, reflecting a reduction in transportation and thereby overall production costs, will enlarge the total surplus area bounded by the D_T^1 and S_T schedules, as drawn in figure 1.

An important final caveat in using these surplus concepts is to bear in mind that natural gas is a resource in the nation's production of final goods and services. Gas is not valued for its own sake, but only as an input in GNP, the production and consumption of which is the ultimate source of social welfare. Our identification of surplus in the natural gas market is at best a stand-in for these ultimate welfare effects, which may not, however, always be realized. In particular, we need to be careful in identifying the surplus of natural gas buyers at various production stages with that of final GNP consumers.

B. Imposition of a Price Ceiling on Old Vintage Gas

Suppose now that a price ceiling of p_O^2 is imposed on sales of old vintage gas. This is shown in figure 2, where the reduced price, p_O^2, results in a reduction of old gas output from q_O^1 to q_O^2. As long as the ceiling is in place, the output of old gas will not go above q_O^2. The effective supply of old gas becomes the schedule S_O^2, which is coincident with the initial schedule, S_O^1, for prices at or below p_O^2 and is otherwise the vertical segment drawn at the quantity q_O^2, at which output is fixed, given the ceiling price p_O^2.

The shift of old supply from S_O^1 to S_O^2 owing to imposition of the price ceiling is reflected in the total supply schedule as an equal leftward shift from S_T^1 to S_T^2. Only that part of S_T above the point designated k^1, drawn on S_T^1 at the height of the ceiling

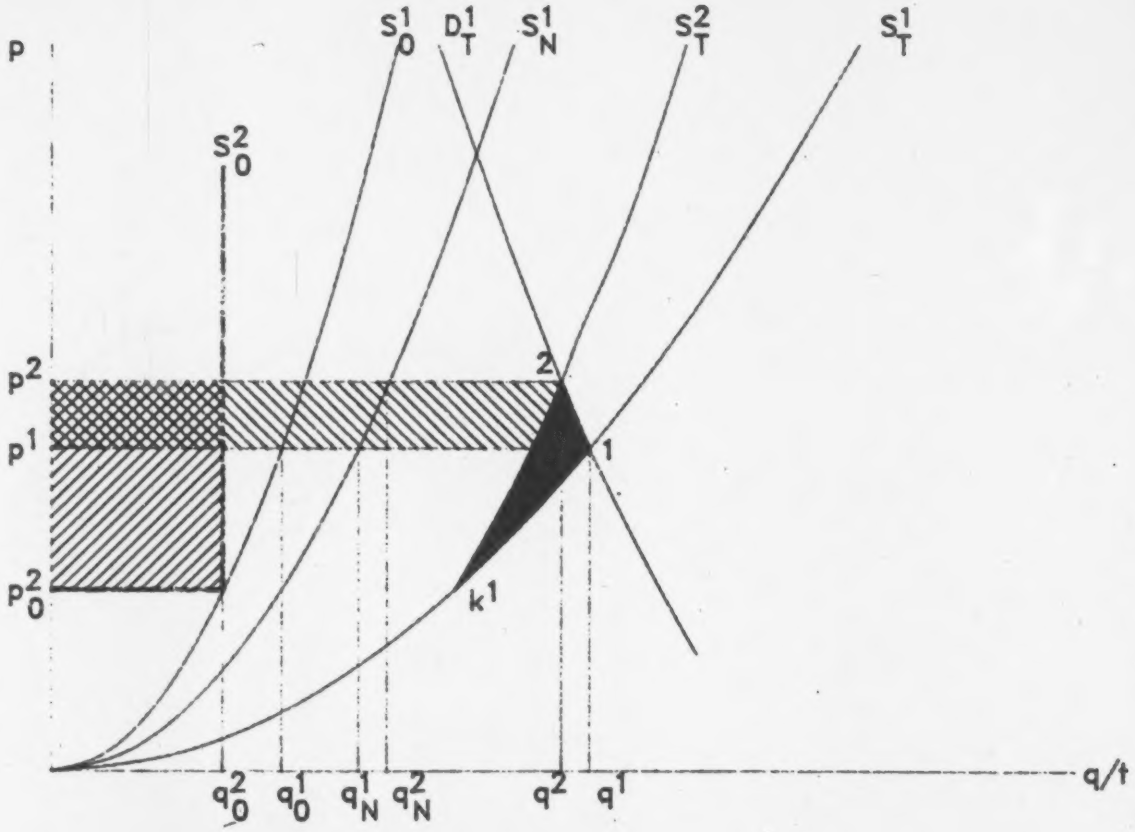

Figure 2. The market for natural gas following imposition of a price ceiling on old vintage gas.

price, follows S_O in rotating to the left. The new schedule S_T^2 thus coincides with S_T^1 for points below k^1 and is in the indicated leftward position for points above k^1.

The shift of S_T to S_T^2 creates a market equilibrium with D_T^1 at point 2. In the new equilibrium, the market-clearing price increases from p^1 to p^2 and the total quantity falls from q^1 to q^2. At p^2, the quantity of new gas produced and supplied rises from q_N^1 to q_N^2, partially offsetting the $(q_O^1 - q_O^2)$ reduction in the quantity of old gas supplied. The substitution of new gas production for old entails the replacement of cheaper old gas, as indicated by the height of the S_O^1 schedule at quantities below q_O^1, by more expensive new gas, as indicated by the relatively greater height of the S_N^1 schedule for quantities above q_N^1.

The social surplus, the sum of consumers' and producers' surplus, following imposition of the price ceiling and the old gas supply response, is the area to the right of the vertical axis up to the quantity q^2, below and to the left of the demand schedule D_T^1, and above the new total supply schedule S_T^2. That area is less than the previous area of total surplus by the size of the triangular area bounded in figure 2 by the schedules D_T^1, S_T^1, and S_T^2 (colored in red). The vertices of the area are $1,2,k^1$. Part of the lost area, the portion below the heavy horizontal segment drawn at the price p^1, corresponds to the area between S_O^1 and S_O^2 below p^1. It is a loss of producers' surplus. The remainder of the lost area, the portion above the price p^1 and bounded by S_T^2 on the left and D_T^1 on the right, is a loss of consumers' surplus.

While the price ceiling creates a net loss of social surplus equal to the triangular area, various larger component gains or losses are simultaneously experienced by the producers of old gas, buyers of old gas, producers of new gas, and consumers. In figure 2, the "rent," as it is called, on old gas is the rectangular area to the left of S_O^2, to the right of the vertical axis, and between the prices p_O^2 and p^2 (cross-hatched in blue). That rent is a windfall which goes to those who have access to and are able to buy the limited quantity of price-controlled old gas. Such buyers may be pipelines, end-users, or other players in the transmission and distribution process. Part of the rent, the portion between prices p_O^2 and p^1, is taken directly from producers of old gas. The smaller rectangle between p^1 and p^2 is a windfall that accrues to the buyers of old gas as a result of the marginal price increase.

Meanwhile, the price rise from p^1 to p^2 confers a gain on producers of new gas equal to the area between those two prices up to the S_N^1 schedule. Equivalently, since, by construction, the distance between the vertical axis and the S_N^1 schedule is the same as the distance between the schedules S_O^2 and S_T^2, the producers' gain is the area between the prices p^1 and p^2 and between the schedules S_O^2 and S_T^2.

Exceeding the sum of the producers' gain and the windfall going to the buyers of old gas as a result of the price rise from p^1 to p^2, is a loss of consumers' surplus equal to the area between p^1 and p^2 from the vertical axis to the D_T^1 schedule (cross-hatched in red). Consumers or end-users of natural gas lose surplus not only on their consumption of the higher-priced new gas, but on the controlled lower-priced old gas as well, up to the total consumption level q^2. That is because the marginal cost of all gas which goes into the production of goods and services in the GNP is p^2, the higher price on the uncontrolled new supply. While the purchase of old gas at the controlled price p_0^2 yields a bonanza to selected buyers, that gain is not available on the marginal unit of gas purchased and so is not passed along to the consumers of final goods and services in which natural gas is an input. As a result of the lower price ceiling on old gas and the higher effective marginal cost on all gas, we can expect some overall increase in the cost of producing the total supply of goods and services in the economy, a reduction in the real GNP, and a consequent higher general level of all prices.

If we balance the windfall to purchasers of old gas plus the additional surplus to producers of new gas against the losses of old gas producers and consumers, the net social welfare change is a loss equal to the (red) triangular area previously identified in figure 2 by the vertices $1,2,k^1$. This net loss, while significant, is essentially only the immediate impact, since over a longer period the individual gross gains and losses may exercise an independent, growing influence. In particular, the existence of a price ceiling has inevitable deterrent effects on investment in facilities for future production of the controlled commodity. This phenomenon is described by Jacoby and Wright as causing the entire supply schedule of natural gas to shift to the left, as government price ceilings revise downward the anticipations of investors and producers as to the long-run profitability of the industry. 2/ Exploration, drilling, and production of gas can all be expected to decline over time in the environment of government price controls.

Such supply responses are also commonly observed in other regulated markets, such as rent-controlled residential apartments, the construction of which is typically sharply depressed. While some volumes of controlled natural gas today are selling at prices below legal ceilings, increased future demand could easily drive prices against their ceilings in the next 4 or 5 years. As long as any controls exist on any gas components, it would require a boundless optimism to assume that future legislation will never decree that today's new gas is not, at some point, old enough to merit price control in some new and unanticipated circumstance. The ultimate potential costs of the old gas price ceiling are thus much greater than the net triangular area balancing direct gains against immediate losses.

To summarize: The imposition of a price ceiling below market level on old vintage gas results in a reduction in the quantity of old gas produced. The total output of gas will also fall, raising the price on new gas, which becomes the market-clearing and marginal price of all gas. In effect, an increment of new gas, which is more costly to produce, is substituted for some of the old gas, whose production cost is less.

2/ Henry Jacoby and Arthur Wright, "The Gordian Knot of Natural Gas Prices," in E. J. Mitchell, ed., The Deregulation of Natural Gas (Washington, American Enterprise Institute, 1982), pp. 129-130.

If we balance out gains and losses of social surplus, the net effect of the ceiling price is a loss of producers' surplus owing to the contraction of old gas output and, because of the higher price of gas, a loss of consumers' surplus that exceeds gains of new producers and windfalls to the buyers of old gas. Both consumers and producers are worse off.

In a longer time frame, the loss to gas producers owing to the price ceiling promises to generate a diminished level of exploration and production and still greater producer losses as the supply schedule of natural gas shifts to the left. These losses, which would further exacerbate consumer losses, could eventually overwhelm the other direct effects occasioned by the control policy.

Meanwhile, the increased marginal price of gas, caused directly by the old gas negative supply response, will raise the cost and reduce the level of all goods and services in whose production natural gas is an input. This supply-induced loss of real GNP will raise the general level of all prices.

C. Rolled-In Pricing

We consider next the introduction of rolled-in pricing, whereby pipelines or distributors sell gas at its average acquisition cost, averaging or "rolling in" the higher price on new gas with the lower controlled price on old gas to form a weighted mean of the two. In this event, consumers, facing the average price, are subsidized in their purchase of new gas and will demand more gas in general than if they faced the true marginal cost, the price of new vintage gas.

We illustrate rolled-in pricing in figure 3, which repeats the essential features of figure 2. Since in figure 3 the prices seen by consumers and producers are not the same, we assume that any given price on the vertical axis above p_O^2 is the price seen by suppliers of new gas. Consumers see a lower price, the average of the new supply price and the lower old supply price weighted by the respective quantities of each. At any price on the vertical scale, the quantity demanded is thus greater than the amount shown at that price on D_T^1. The demand quantity instead is the quantity on D_T^1 corresponding to the lower associated average price. A demand schedule, D_T^2, lying to the right of D_T^1 and incorporating the quantities on D_T^1 demanded at the average prices lying below each of the scaled prices on the vertical axis, is now the effective demand.

The new equilibrium determined by S_T^2 and D_T^2 is at point 3, at which the uncontrolled price has been bid up to p^3 and the market-clearing quantity is higher at q^3. 3/ At p^3, which is

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3/ Depending on supply elasticities, the new quantity q^3 could lie to right of q^1, instead of between q^2 and q^1, as drawn. The higher the elasticity of SN, the more likely will q^3 exceed q^1.

Under the 1970s' crude oil entitlements program, which was a formal rolled-in pricing system, the supply of oil at the world price was, for many purposes, assumed to be perfectly

(Footnote Continued)

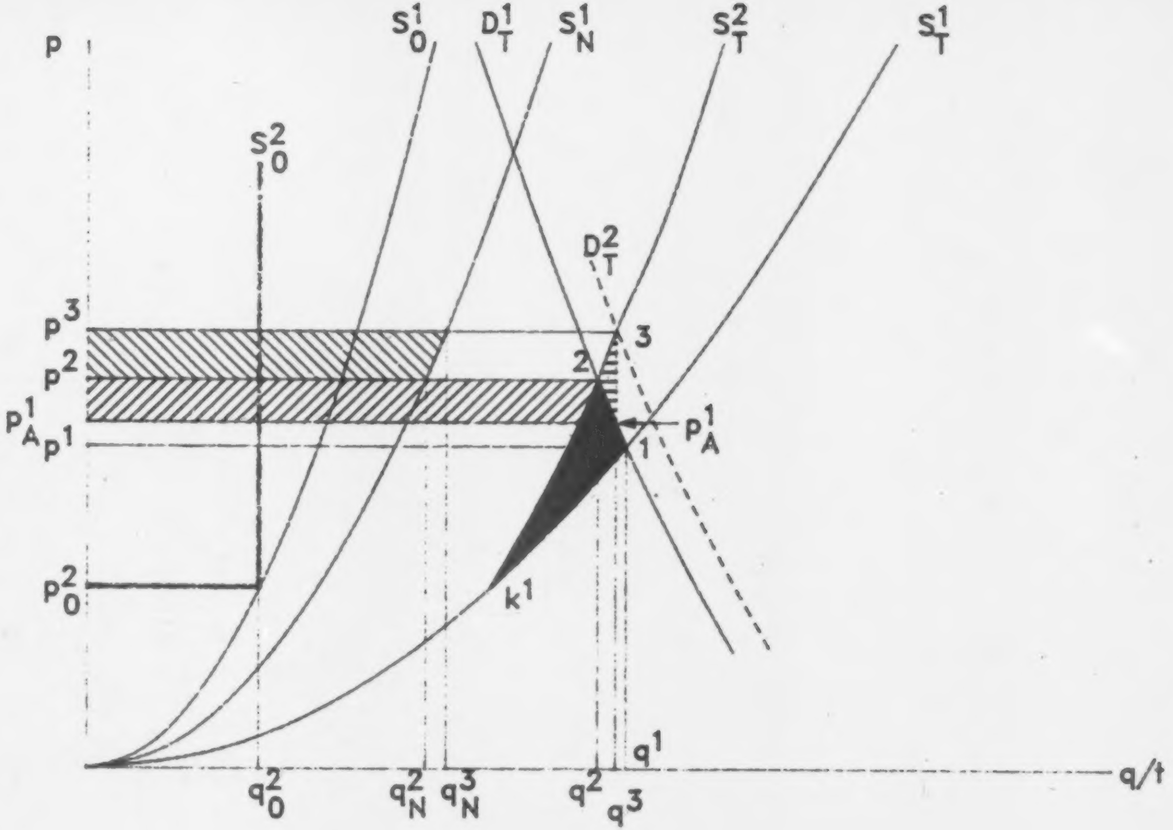

Figure 3. The market for natural gas under controlled old gas prices and rolled–in pricing.

the price received by producers of new gas, the quantity of new gas supplied is q_N^3, up from q_N^2 at the previous equilibrium price of p^2.

The willingness of consumers to buy a total market quantity of q^3, while an uncontrolled price or marginal cost of p^3 prevails in the market, is explained by the fact that the weighted average of p^3 and p_O^2 is p_A^1, the price on the initial demand schedule, D_T^1, corresponding to the quantity q^3. 4/ If p_A^1 were not thus located on D_T^1, consumers would not be willing to purchase q^3.

Price averaging reduces further the social surplus in the natural gas market. This can be seen in figure 3 directly by simply observing that under the price control/price averaging regime, the quantities between point k^1 and q^3 are produced by a supply schedule S_T^2 for which the total costs of production (the area under the supply schedule) exceed the costs incurred in the unregulated market by the area between S_T^2 and S_T^1. That is

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(Footnote Continued)

elastic (flat). In that circumstance, the increased demand resulting from the entitlements invariably raised consumption above the pre-entitlements level. See G. Horwich and D. L. Weimer, Oil Price Shocks, Market Response, and Contingency Planning (Washington, D.C., American Enterprise Institute, 1984), pp. 71-72.

4/ Our ability to plot p_A^1 on the vertical axis assumes the existence of an implicit second scale in addition to the one used to plot new gas prices.

the triangular area whose vertices are k^1,3, and the intersection of q^3 and S_T^1. To that triangular area we add a small triangle to the right of the bold-faced vertical segment at the quantity q^3 and bounded by D_T^1 and S_T^1. The small triangle is an additional component of consumer and producer surplus that is lost in moving away from the unregulated market to one of controls and price averaging.

The loss of social surplus attributable only to the price averaging is the (red) cross-hatched triangle whose vertices are 2,3,p_A^1, since the larger (solid red) triangle, 1,2,k^1, was previously identified as the loss due to imposition of the price ceiling on old gas prior to price averaging. The area 2,3,p_A^1 has a special interpretation. It is a cost incurred in going from the quantity q^2 to q^3, induced by price averaging, that exceeds the value consumers place on that additional quantity as shown by the height of the underlying demand schedule D_T^1. It is thus, from an economic viewpoint, wasteful consumption.

Rolled-in pricing in effect transfers the rent on old gas from pipelines and other intermediate buyers to consumers, for whom the average and effective marginal price is lowered, and to producers of new gas, for whom the price received is raised further. In figure 3, consumers gain the (blue) cross-hatched area between the prices p^2 and p_A^1 and extending from the vertical axis to the D_T^1 schedule. Producers of new gas gain the (green) cross-hatched area between p^2 and p^3 and between the vertical axis and the S_N^1 schedule, or, equivalently, between the schedules S_O^2 and S_T^2.

The addition to producer revenues can be regarded as offsets, in some degree, to the disincentives imposed on producers whose old gas has been brought under the price ceiling. These effects are in no sense, however, a substitute for the substantial economic benefits that would come from full decontrol.

D. Block Billing

Under the block billing proposal, pipelines will be required to charge separately for each of the two major vintages of gas and to cease rolling in or averaging the uncontrolled price with the controlled price. This moves the market back from the equilibrium in figure 3 at point 3 to the equilibrium at point 2. With demand no longer subsidized by price averaging, consumers and producers of new gas will see the same price, at any level of which along the vertical scale the effective demand quantity is once again given directly by D_T^1. With effective demand shifting from D_T^2 back to D_T^1, the price on new gas drops from p^3 to p^2, which is necessarily greater than p_A^1, the weighted average of p^3 and p_O^2 that consumers were paying under rolled-in pricing. At the same time, the market-clearing quantity falls back from q^3 to q^2.

In essential respects, block billing restores the regime of old gas price controls without price averaging, as described in Section B above. Producers see a lower marginal price and diminished revenues; consumers and other end-users see a higher marginal price to which they respond with reduced purchases.

Block billing, as proposed by FERC, allocates old gas to users on a historical use basis. Insofar as consumers share in the allocation, it is their only direct source of gain under block billing. The gain of consumers is at the expense of pipelines and other intermediate purchasers who lose out in the allocation.

In figure 3 the losses to producers of new vintage gas correspond to the (green) cross-hatched area between the prices p^2 and p^3 and between the vertical axis and the S_N^1 schedule (or the equivalent distance between the schedules S_O^2 and S_T^2). For consumers, the losses are equal to the (blue) cross-hatched area between the prices p^2 and p_A^1 and between the vertical axis and the schedule D_T^1. Consumer gains, flowing from the claim to old gas, would be some or all of the area lying between the prices p^2 and p_O^2 and between the vertical axis and the schedule S_O^2.

The net efficiency gain, represented by the (red) cross-hatched triangle in figure 3, $2,3,p_A^1$, is estimated at $500 million per year. 5/ But even this is a high figure. Historical use allocation will introduce widespread inefficiency in the use of old gas by consumers, inhibiting the flow to most-valued uses. The economic misallocation will increase over time as supply and demand patterns constantly shift away from the historical base. By contrast, consumers are free to allocate old vintage gas that comes to them under rolled-in pricing to the highest-valued uses they may determine.

5/ Department of Energy, Comments on the Federal Energy Regulatory Commission's May 30, 1985 Notice of Proposed Rulemaking, Washington, D.C., July 15, 1985, p. 47. The figure cited by DOE is $2.2 billion, which is the present (Footnote Continued)

Once again, this relatively minor short-run balance of the revenue and surplus changes does not begin to measure the ultimate potential impact on welfare of the proposed policy. For producers, the estimated revenue losses are sizable, ranging from $1.5 billion to $5 billion per year. 6/ These losses cannot fail to discourage future exploration, drilling, and the production of natural gas. The investment deterrent could thus ultimately reduce social welfare and GNP by an amount that far exceeds any small direct efficiency gain of block billing. 7/

E. Removal of the Price Ceiling

A way to eliminate the negative production and consumption impacts of block billing is, of course, to remove the ceiling on old gas and return the market to its original uncontrolled state. In figure 2 the equilibrium would return to point 1 and the price of new gas would fall from p^2 to p^1 while that of old gas would rise from p_O^2 to p^1. The marginal cost of gas, which both producers and consumers face, would be the only price prevailing in the market. At the same time, the total market quantity would rise

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(Footnote Continued)

value of the gains from 1985 to 1995 discounted at 10 percent. An estimate of the first year's benefit is $500 million. The series declines in succeeding years.

6/ Estimates provided by Foster and Associates, November 1985.

7/ A further factor limiting any possible gain from block billing is that local distribution companies, not subject to FERC jurisdiction, may themselves roll in prices. That tendency would effectively offset block billing by the interstate pipelines.

to q^1 as the original S_O schedule reasserts itself and additional quantities of old gas come on stream. The Department of Energy estimates a ten-year increase in production under decontrol of 38 trillion cubic feet, 4 trillion cubic feet in the first year alone. [8]

In view of these price and quantity changes, rents on the q_O^2 quantity of old gas valued at $p^1 - p_O^2$ would revert to producers of such gas. The rent on q_O^2 valued at $p^2 - p^1$ would disappear, as would new gas revenues between the horizontal lines at p^2 and p^1 up to the S_N^1 schedule -- or, equivalently, between the schedules S_O^2 and S_T^2. Exceeding these new vintage producer losses would be consumer gains lying between the prices p^2 and p^1 and extending all the way to the D_T^1 schedule. Producers of old gas would also recoup their revenue and surplus, identified earlier as the area between S_O^1 and S_O^2. On net, the (solid red) area of lost producers' and consumers' surplus, the triangle $1,2,k^1$, is restored to the market. Underlying the net gain are thus individual gains both by consumers and producers who, in the first instance, are estimated to gain more on old gas than they lose on new gas. [9]

A partial move to decontrol is illustrated in figure 4, in which the old vintage price ceiling is raised by less than the

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[8] Department of Energy, Comments on the Federal Energy Regulatory Commission's May 30, 1985 Notice of Proposed Rulemaking, op. cit., p. 51.

[9] This is the result of back-of-the-envelope calculations, based upon the geometric areas of figure 2 plus plausible elasticity assumptions.

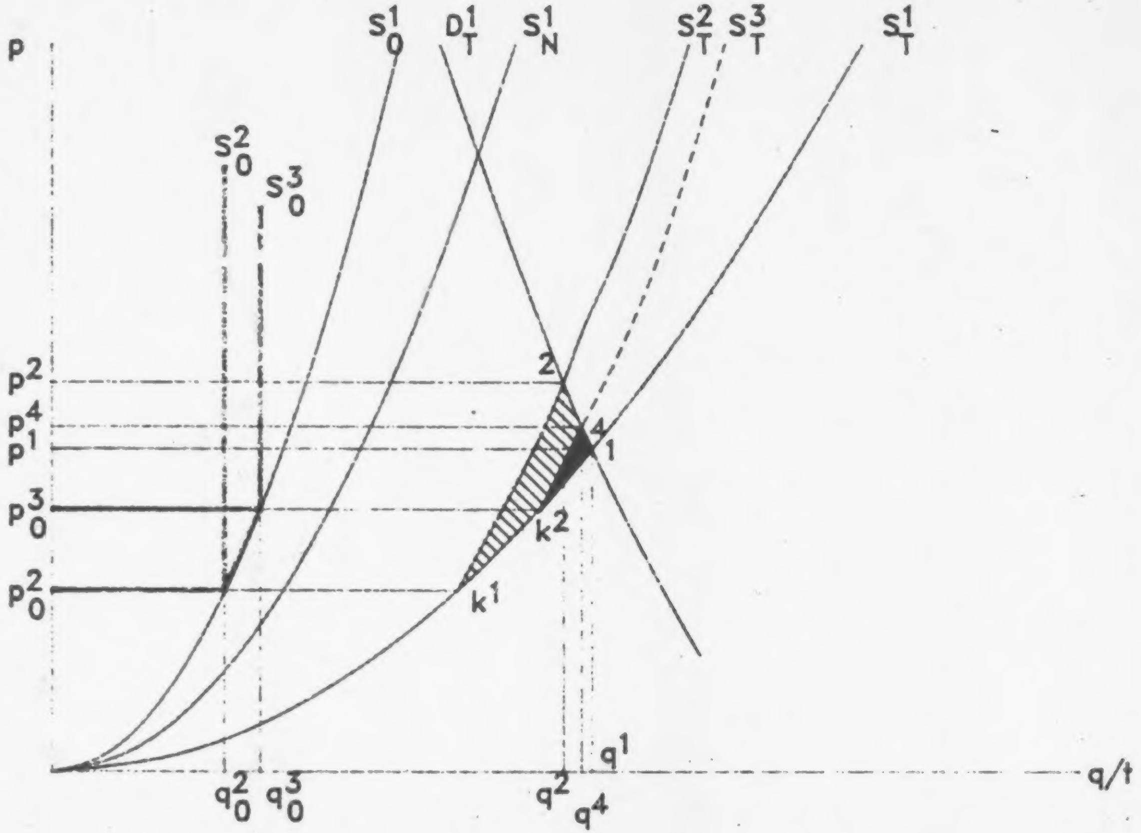
p
S_0^1
D_T^1
S_N^1
S_T^2
S_T^3
S_T^1
S_0^2
S_0^3
p^2
p^4
p^1
p_0^3
p_0^2
2
4
1
k^2
k^1
q^1
q/t
q_0^2
q_0^3
q^2
q^4

Figure 4. The market for natural gas under partial decontrol of gas prices and block pricing.

full distance to market clearing. We start with the previous ceiling price of p_O^2 and an equilibrium without rolled-in pricing at point 2. In figure 4 the price ceiling on old gas is raised from p_O^2 to p_O^3. At p_O^3 the quantity of old gas supplied rises to q_O^3. The schedule of old gas supply shifts to S_O^3, which, for prices above p_O^2, lies to the right of S_O^2. A new schedule of total supply, S_T^3, reflecting the shift of old supply, is drawn to the left of S_T^1 starting at the point k^2, the height of which is the new ceiling price, p_O^3. S_T^3 is to the right of S_T^2 and intersects the demand D_T^1 at point 4. In this new equilibrium, price p^4 is below the previous price p^2, and quantity q^4 is above the previous quantity q^2.

The increase in the ceiling price, as indicated in the diagram, is roughly only half of the distance to market clearing at p^1. Nevertheless, the net gain in social surplus is substantial. The net loss, represented by the colored area, is reduced from the larger triangle, $1,2,k^1$, to the much smaller (solid red) triangle, $1,4,k^2$. The gain from partial decontrol is the (green) cross-hatched area, $2,k^1,k^2,4$.

As at every previous stage of the analysis, the area of net gain or loss does not begin to capture the long-run impact, including, in this case, the full benefits of allowing the market to function under fully rational pricing unencumbered by arbitrary transfers. Arrow and Kalt, in discussing crude oil decontrol in their chapter, "Regulating Crude Oil Prices: Gainers and Losers," in the Ford Foundation study, Energy: The Next Twenty Years, state that neither the gross measured efficiency gains and losses of decontrol nor the net measured gains -- the balance of the various geometric areas -- may be large. But, more fundamentally, decontrol could

> have the exceedingly salutary effect of reassuring suppliers about the market value of the new supplies that they may bring on the market, of inducing consumers to anticipate the genuine higher future costs of liquid fuels, and of stimulating technology in response to the genuine higher cost of domestic or imported liquid fuels.
>
> Together, these effects, which were not explicitly taken into account in the short-range nondynamic estimates of what we called "efficiency" above, could easily be ten times, or more than ten times, as important as the narrowly defined efficiency gains . . . 10/

F. Comments on Exhibit S

The major analytical defense by FERC of its block billing proposal is set forth in "An Economic Analysis of Supply Adequacy in the Natural Gas Industry," a statement identified as Exhibit S. 11/ This statement is a quite detailed exposition and manipulation of a model of natural gas supply and demand, including not only the usual flow components, but inventories.

The analysis is not always easy to follow. A particular source of difficulty is the description of inventory accumulation, whose relevance to the issues at hand is not clear. In some passages, as on page 35, demand increases result in decreases

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10/ Ford Foundation, Energy: The Next Twenty Years (Cambridge, Ballinger, 1979), pp. 198-199.

11/ Federal Energy Regulatory Commission, Notice Requesting Supplemental Comments (Issued October 9, 1985), Docket No. RM85-1-000 (Part D).

in the quantity sold, for reasons that are not apparent. In other passages, however, the analysis of supply or demand shifts seems basically compatible with our own; i.e., price and quantity variables tend to move in the expected direction. This is true of the analysis of an increase in supply (pages 35-36) and of the adoption of block billing (pages 31-32, 44, and Part Three, page vii), where such pricing is interpreted, correctly in our view, as the removal of an artificial prop to demand. The analysis of a removal of the old gas price ceiling is also compatible with our own, except that Exhibit S assumes throughout that there is no old-gas supply response to price (pages 28-29, Part Three, pages vi-vii). While this assumption is introduced purely for analytical convenience, the failure to relax it anywhere in the paper omits the key variable in the case for total decontrol.

The major deficiency of Exhibit S is that it does not address the fundamental issue raised by block billing; i.e., the loss of revenues by producers of new gas and the consequent disincentive to long-run exploration and supply. This is clear at the very start of the essay on page 2, where the first of four principal conclusions of the study is that "block billing will not create a natural gas shortage." The third conclusion adds, in a similar vein, that block billing combined with open transportation will reduce "the risk of supply deficiencies."

In economics, the term "shortage" has a precise technical meaning; namely, that the prevailing market price of a commodity is one at which the desired demand quantity exceeds the supply quantity. This, of course, can occur only if the price is artificially or otherwise held below the market-clearing level.

That Exhibit S is using the word "shortage" in its technical sense, and, at the same time, referring to the absence of shortage as evidence of an adequate supply, is clear in a number of passages. Before citing those passages, the major point we wish to make is that the absence of shortage in the technical sense has no bearing on whether or not the absolute level of supply is large or small, adequate or inadequate by economic criteria. Supply and demand can be equal at exceedingly low levels of supply, a possibility that proponents of block billing are obligated to address and that Exhibit S ignores. The present structure of the natural gas and U.S. energy markets would in fact tend to preclude natural gas shortages in the technical economic sense no matter how depressed the absolute level of gas supply becomes.

The equivalence between the absence of "shortage" in the technical sense and "adequacy" of supply, as used by Exhibit S, is apparent on page 35, paragraph 1, where the market, under given assumptions, is said to insure "supply adequacy" in response to various supply and demand shifts. The conclusion at the close of the paragraph, following the analysis, is that, indeed, behavior adjusts "so as to equate quantities supplied and quantities demanded."

On page 36: "Parties will be induced by market interactions to adjust . . . and restore an equality between production and use . . . In short, adequate supplies [are] provided by market incentives." And, once again, on page 43: ". . . the market will induce adjustments to those changes by creating incentives to restore equality between quantities demanded and . . . supplied." Therefore, "one must conclude that shifting from rolled-in billing to block billing will do nothing to adversely affect the ability of the market to create adequate supplies . . ."

The ability of the gas market to clear; i.e., for total supply and demand to meet at a common price and quantity, derives from the existence of at least one uncontrolled market segment into which unsatisfied demand from other markets can flow freely. The new gas market, of course, serves the clearing function, much as purchases of oil imports at the uncontrolled world price succeeded in clearing the controlled domestic crude oil market in the 1970s.

Both our model and that of Exhibit S feature an uncontrolled new vintage price. That both models always clear in the aggregate and do not generate shortages in the technical economic sense under any of the schedule shifts or other shocks considered is thus not surprising. Equating market-clearing with "supply adequacy," however, is an unwarranted use of language and misses completely the current concerns regarding longer-term natural gas supply. If, by sharply reducing producer revenues, block billing depresses new supply, the fact that supply nevertheless remains in balance with demand would be a matter of small consequence. It is the absolute level of supply in the longer term that concerns energy policy, and in terms of which the block billing proposal has to be evaluated.

In the first instance, with the aggregate demand schedule unchanged (at D_T^1 in the graphs above), a leftward shifting supply schedule (S_T) would tend to create higher and higher prices at the aggregate supply/demand intersection. The availability of alternative fuels, however, such as fuel oil, would cause the demand schedule also to shift to the left as gas consumers moved into the cheaper alternatives. The result would be a depressed level of both the supply and demand schedules, equality between reduced-level supply and demand quantities, and no necessary significant increase in price. Since the marginal source of oil is the import market, the longer-term reductions in gas supply would in effect have been met by increases in oil imports.

To summarize: The major failing of Exhibit S is its identification of supply adequacy in natural gas with the absence of a shortage -- an imbalance between supply and demand -- in the technical economic sense. The existence of an uncontrolled segment of the gas market and of other energy markets, as well, enables the gas market to clear at some price. But market clearing can, and, potentially, under block billing, could clear at low absolute levels of supply. At the same time, the availability of gas substitutes will limit the price increases that normally accompany supply losses.

It is, finally, not without irony that Exhibit S can proclaim that supply adequacy, under any definition, characterizes the U.S. natural gas industry. Half of the industry output remains under controls that have discouraged exploration and drilling in the interstate market on a broad scale for almost two decades. 12/

12/ See the econometric estimates to this effect by Robert Pindyck in "Prices and Shortages: Policy Options for the Natural Gas Industry," in *Options For U.S. Energy Policy* (San Francisco: Institute for Contemporary Studies, 1977), pp. 143-177.

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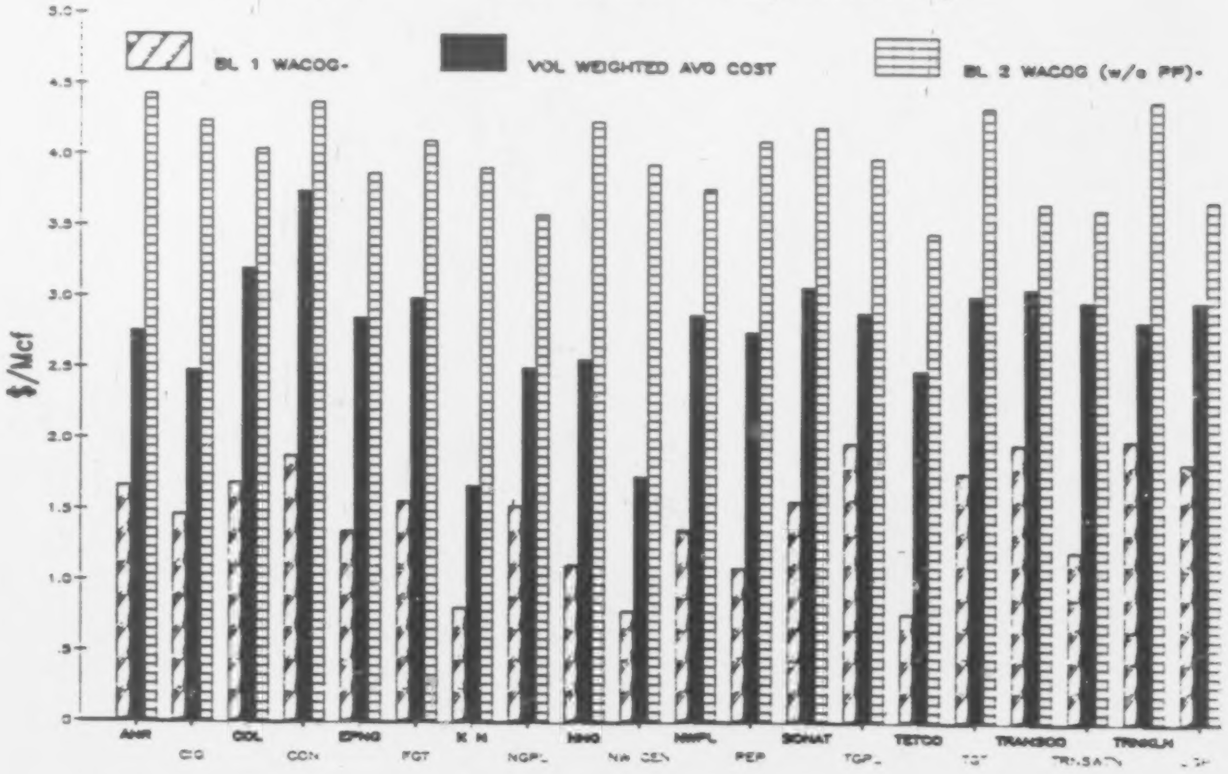
COMMENTS OF THE PETROCHEMICAL ENERGY GROUP

Subcommittee on Energy,
Regulation and Conservation
Committee on Energy and Natural
Resources
United States Senate

November 21, 1985

Washington, D.C.

AVERAGE COST OF WELLHEAD PURCHASES
(Mid-1985 PGA Projections)

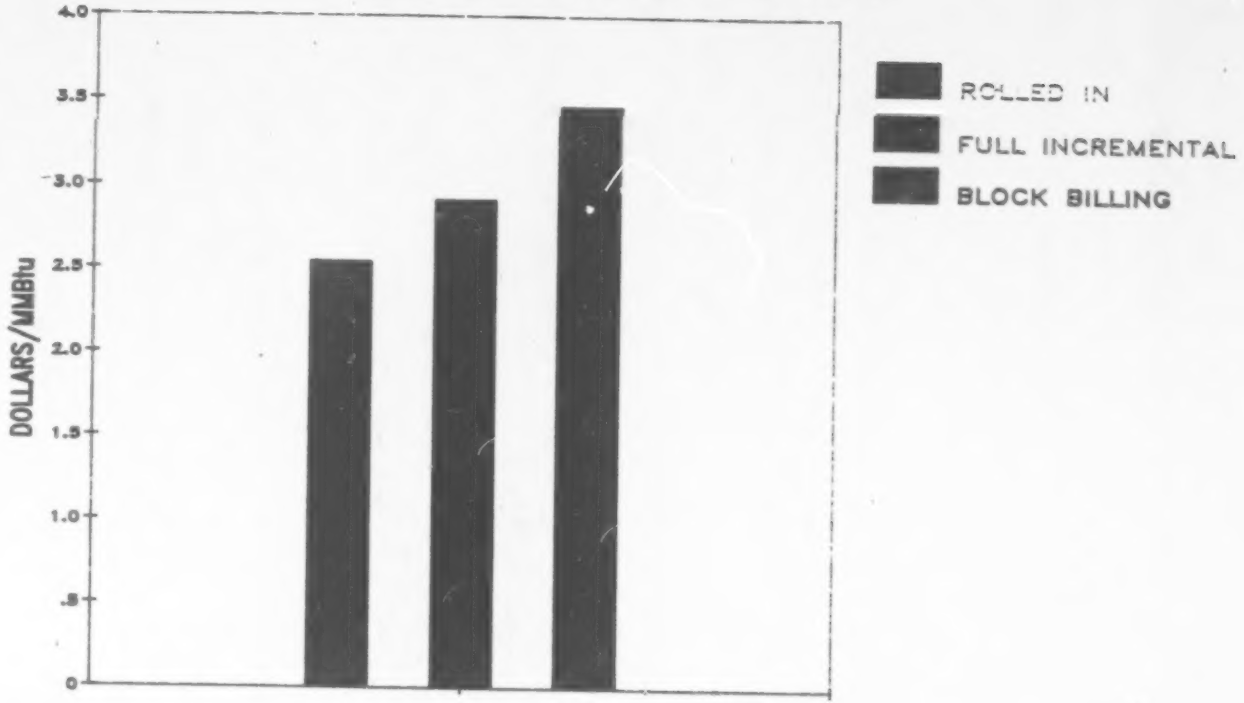


SOURCE: EIA

-As defined in RM85-1

PEG CHART 1

IMPACT ON INDUSTRIAL USER FULL INCREMENTAL PRICING VERSUS BLOCK BILLING



SOURCE: EIA Late 1985 PGA Data: Wellhead Purchases

CHART 2

CHART 3
Page 1 of 3

SMP ACTIVITY /a/

COMPANY	MONTH	VOLUMES SOLD/MMBTU	PRICES ($/MMBTU)
CITIES SERVICE (COGS)	2/85	203,000	$2.71 - 2.03 /b/
AMOCO PRODUCTION (ASMP)	2/85	95,195	$2.05 /c/
UNION TEXAS PETROLEUM (UPET)	2/85	456,260	$2.75 /b/
TENNECO INC. (TENNEFLEX)	2/85	2,900,000	$2.93 (average) /b/
PANHANDLE/TRUNKLINE (PANMARK)	2/85	7,900,000	$3.11 /c/e/
TENNESSEE GAS (TEMPRO)	2/85	4,966	$2.00 /d/
COLUMBIA GAS (SMP Pool)	2/85	4,300,000	$3.57 /c/
	---------OTHER SPOT PRICES /c/---------		
TENNGASCO (VINTON, LA.)	5/85		$2.63 /f/
TENNGASCO (TIVOLI, TX)	5/85		$2.56 /f/
COLUMBIA GAS	5/85		$2.75 /g/
EL PASO NAT. GAS	5/85		$2.65 /g/
HOUSTON PIPE LINE	5/85		$2.58 /g/
PANHANDLE EASTERN	5/85		$2.60 /g/

/a/ Based on monthly reports submitted by the companies to FERC
/b/ At the wellhead
/c/ Nomination point
/d/ Price paid to supplier
/e/ Weighted average price
/f/ Price reported by Tenngasco Exchange
/g/ Price reported by U.S. Natural Gas Clearinghouse

Composited by Baker & Botts

CHART 3
Page 2 of 3

SMP ACTIVITY /a/

COMPANY	MONTH	VOLUMES SOLD/MMBTU	PRICES ($/MMBTU)
CITIES SERVICE (COGS)	6/85	1,444,061	$2.50 - 2.75 /b/
AMOCO PRODUCTION (ASMP)	6/85	191,374	$2.85 /c/
UNION TEXAS PETROLEUM (UPET)	6/85	61,950	$2.70 - 2.75 /c/
TENNECO INC. (TENNEFLEX)	5/85	6,017,459	$3.12 /c/
PANHANDLE/TRUNKLINE (PANMARK)	6/85	4,076,969	$2.80 /c/ /e/
TENNESSEE GAS (TEMPRO)	6/85	2,922,010	$2.80 /c/
COLUMBIA GAS (SMP Pool)	6/85	3,403,562	$3.52 /c/
		---------OTHER SPOT PRICES /c/---------	
TENNGASCO (VINTON, LA.)	8/85		$2.26 /f/
TENNGASCO (TIVOLI, TX)	8/85		$2.26 /f/
COLUMBIA GAS	8/85		$2.40 /g/
EL PASO NAT. GAS	8/85		$2.35 /g/
HOUSTON PIPE LINE	8/85		$2.30 /g/
PANHANDLE EASTERN	8/85		$2.30 /g/

/a/ Based on monthly reports submitted by the companies to FERC
/b/ At the wellhead
/c/ Nomination point
/d/ Price paid to supplier
/e/ Weighted average price
/f/ Price reported by Tenngasco Exchange
/g/ Price reported by U.S. Natural Gas Clearinghouse

Composited by Baker & Botts

CHART 3
Page 3 of 3

SMP ACTIVITY /a/

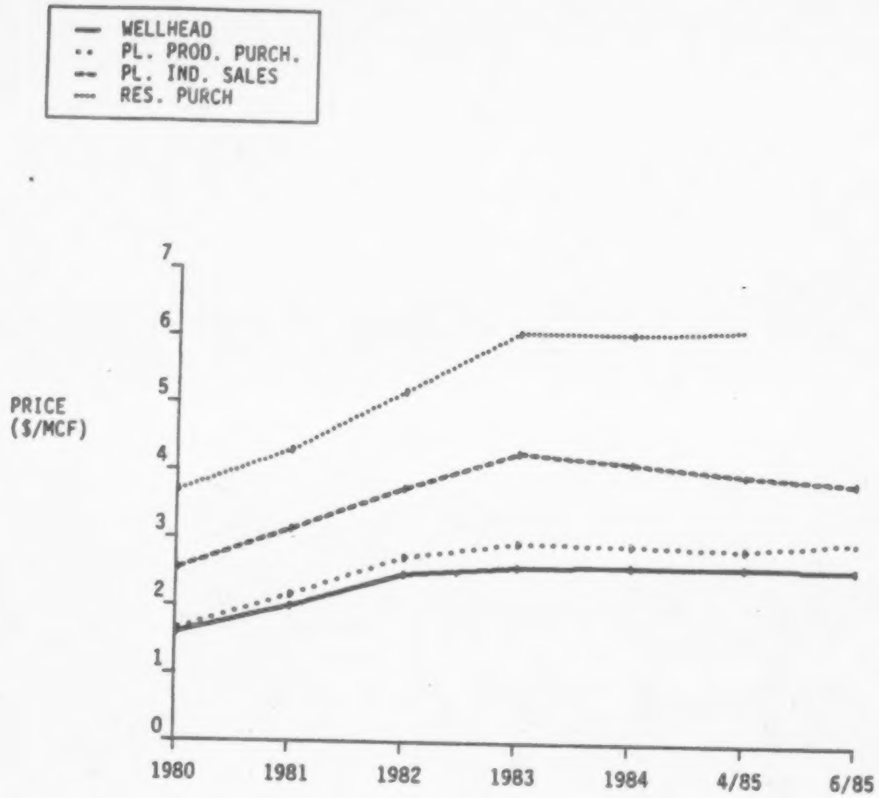
COMPANY	MONTH	VOLUMES SOLD/MMBTU	PRICES ($/MMBTU)
AMOCO PRODUCTION (ASMP)	7/85	81,879	$2.85 /d/
CITIES SERVILE (COGS)	8/85	579,796	$2.26 - 2.61 /b/
			$2.83 - 3.86 /e/
CITIZENS ENERGY SMP	8/85	632,821	$2.33 /b/
			$2.90 - 3.10 /d/
CONOCO	8/85	183,350	$2.30 /c/
			$3.21 /d/
COLUMBIA GAS (SMP POOL)	8/85	8,339,645	$2.63 /b/
			$2.84 /c/
DIAMOND SHAMROCK	8/85	390,263	$2.36 /c/
			$3.55 - 3.70 /d/
EXXON SMP	8/85	729,233	$2.23 /b/ /f/
KERR MCGEE	8/85	780,572	$2.40 /c/ /f/
PANHANDLE/TRUNKLINE (PANMARK)	8/85	4,664,577	$2.68 /b/ /f/
			$3.46 - 4.45 /d for end users/
			$2.97 - 3.66 /d for resale/
SHELL OFFSHORE	8/85	1,282,876	$2.27 - 2.36 /b/
			$2.36 /c/
			$2.83 /e/
TXP OPERATING TRANSMART	8/85	3,821,246	$2.00 - 2.40 /c/
			$2.56 - 2.96 /d/
TENNECO INC. (TENNEFLEX)	8/85	6,285,701	$2.41 /b/
			$2.86 /c/
TENNESSEE GAS (TEMPRO)	8/85	1,743,750	$2.00 - 2.39 /b/
TEXAS GAS SMP	8/85	130,731	$2.55 - 2.80 /c/
			$2.82 - 3.13 /d/
UER MARKETING	8/85	1,211,114	$2.20 /c/
			$2.54 /d/
WALTER OIL & GAS	8/85	330,371	$2.30 - 2.40/b/
			$2.79 - 2.85 /d/
---------OTHER SPOT PRICES /c/---------			
TENNGASCO (VINTON, LA.)	11/85		$2.83 /g/
TENNGASCO (TIVOLI, TX)	11/85		$2.81 /g/
COLUMBIA GAS	10/85		$2.20 /h/
EL PASO NAT. GAS	10/85		$2.20 /h/
HOUSTON PIPE LINE	10/85		$2.15 /h/
PANHANDLE EASTERN	10/85		$2.10 /h/

/a/ Based on monthly report published by Natural Gas Intelligence (10/21/85)
/b/ At the wellhead (netback price)
/c/ Nomination point
/d/ Delivered price
/e/ City gate price
/f/ Weighted average price
/g/ Price reported by Tenngasco Exchange
/h/ Price reported by U.S. Natural Gas Clearinghouse

Composited by Baker & Botts

CHART 4

GAS PRICES OVER A SIX-YEAR PERIOD



COMPOSITED BY BAKER & BOTTS

SOURCE: EIA MONTHLY ENERGY REVIEW
(OCTOBER 1985)

EXECUTIVE SUMMARY

1. Block billing is inconsistent with incremental pricing. Congress and the FERC have decided that the incremental pricing surcharge should be limited. The impact of block billing on industrial users of natural gas is potentially far greater than under incremental pricing.

2. Under block billing, industrial users also fear that long-term gas supplies will be adversely affected, resulting in curtailments of supplies in the future.

3. Rather than enhancing transportation, Order No. 436 has, in fact, greatly curtailed industrial consumers' access to transportation. Industrial customers are again situated as captive customers of single suppliers.

4. The structuring of pipeline transportation rates proposed in Order No. 436 makes it doubtful that pipelines who participate in the new transportation program will be rewarded.

5. Order No. 436 denies industrial gas users non-discriminatory access to firm transportation capacity.

6. Order No. 436 creates a regulatory process in which current suppliers can use the regulatory process to block transportation on behalf of industrial gas users.

7. Order No. 436 provides no remedy for the refusal by local distribution companies to transport gas, or to avoid the imposition of prohibitive transportation rates by local distribution companies. As a condition to receiving the benefits under Order No. 436, local distribution companies should be required to agree to transport gas on a non-discriminatory basis.

8. We support continued efforts to correct the problems Order No. 436 has created.

COMMENTS OF THE PETROCHEMICAL ENERGY GROUP

The Petrochemical Energy Group, or PEG, is a group of independent petrochemical companies--those companies which are not vertically integrated with major refiners. 1/ Members of the Petrochemical Energy Group use gas for boiler fuel, feedstock, process fuel, plant protection, and other non-boiler uses. Our members have manufacturing facilities in all parts of the United States. PEG members are participating or seeking to participate in the spot and longer term non-traditional gas markets.

PEG would like to comment on the block billing proposal on which the Federal Energy Regulatory Commission ("Commission") has requested public comment 2/ and on the final rule in Order No. 436 issued by the Commission on October 9. 3/ Order No. 436 has created immediate and urgent problems. Transportation of natural gas for

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1/ The U.S. petrochemical industry is vital to the economic welfare of the United States, and is a key contributor to the nation's trade balance. U.S. petrochemical industry sales in 1983 were nearly $80 billion. The industry employed 360,000 people, and invested $4 billion in new plant and equipment in the U.S. (See 1983 Petrochemical Industry Profile, Arthur D. Little, Inc., September 1, 1984.) The industry made a $7 billion positive contribution to the national balance of trade in 1983. (See Trade Trends in Petrochemicals: 1983, Arthur D. Little, Inc., August, 1984.)

2/ 50 Fed. Reg. 42372 (October 18, 1985).

3/ 50 Fed. Reg. 42408 (October 18, 1985).

industrial users and for distributors who serve residential, commercial and industrial users has been greatly curtailed by certain of its provisions. In addition, there are provisions in Order No. 436 which will discourage interstate pipelines from transporting natural gas even if they decide to accept the terms and conditions presently proposed for their participation in the new transportation programs.

Block Billing

First, we would like to address the block billing proposal.

Block billing is inconsistent with incremental pricing.

In the Natural Gas Policy Act of 1978 (NGPA), 4/ the Congress expressly addressed the circumstances under which industrial users of natural gas would be subjected to prices above the rolled in price.

In Title II, the Congress specified:

- which NGPA Title I categories of gas would go into the second block, called a surcharge account and in what amounts; 5/
- that certain industrial boiler fuel uses would pay the amount in block 2 or the surcharge amount 6/

4/ 15 U.S.C. §§ 3301-3432 (1985).

5/ 15 U.S.C. § 3343 (1985).

6/ 15 U.S.C. § 3341 (1985).

and left open the question of whether all industrial uses of gas would be subjected to the surcharge 7/ and whether certain exemptions should be granted; 8/

- placed a cap on the amount that industrial gas users would have to pay. 9/

Subsequently, both the Congress, by its action in vetoing a broader application, 10/ and then the Commission 11/ decided that the incremental pricing surcharge should be limited to industrial boiler fuel uses.

Block billing is inconsistent with the policy and the law of the NGPA. Please look at Chart 2. Using EIA data for late 1985, this chart compares the price of gas to the industrial user under rolled-in pricing, under incremental pricing, and under block billing. Please note that:

7/ 15 U.S.C. § 3342 (1985).

8/ 15 U.S.C. § 3346 (1985).

9/ 15 U.S.C. § 3344(e) (1985).

10/ H.R. Res. 655, 96th Cong., 2d Sess., 126 Cong. Rec. H3855 (daily ed. May 20, 1980).

11/ Order No. 363, 26 F.E.R.C. ¶ 30,547 (March 15, 1984), (Rule Required Under Section 202 of the Natural Gas Policy Act).

Rolled-in pricing	$2.55
Full Incremental pricing	$2.92
Full Block 2 pricing	$3.47

By "full incremental pricing" we are showing the maximum impact without regard to the cap placed on the surcharge by the Congress and imposing the surcharge on all industrial uses of gas, not just the boiler fuel segment.

By "full block 2 pricing" we are showing the effect if one of three of the possible outcomes forecast by the Commission comes to pass--and not even the Commission ventures a guess as to whether, on a state-by-state basis, the block 1 gas will be allocated to:

(a) the residential and commercial customers first, with industrials receiving only block 2 gas;

(b) all customers pro rata, meaning that the rolled-in price will be maintained;

(c) "price sensitive" customers, which apparently means that industrial and electric utility customers with the ability to switch fuels will get the block 1 gas and the residential, commercial, and high priority industrials who must have gas will get the block 2 gas.

This uncertainty means that each state may adopt a different policy, and the industrial base of jobs and production will be subjected to the potential of widely divergent policies. Those that can will switch to those states with the best policy; those that can't switch to other plants will have to change fuels or cut back. As industrials leave the line, it is the residential and commercial customers who pick up the costs.

Chart 2 illustrates the comparison of block billing with incremental pricing on a nationwide basis. Now please examine Chart 1, a chart that shows the price of gas on the major interstate pipelines as of mid-85, with and without block billing. You can see from this chart that the comparison of incremental pricing on a nationwide basis does not begin to show how serious the situation is, when one contemplates the situation on individual pipelines.

Chart 1 illustrates also that the cushion problem does not go away simply by transferring the old gas to a new federal entitlements program. The cushion becomes even more difficult under block pricing.

And it does appear to us that the block pricing rule and entitlements programs will affect the price of gas at the wellhead of both regulated and deregulated gas. This effect is not the result of the free market, but rather is the result of a change in federal regulation. In the past, federal regulations affecting the price of gas at the wellhead have led to curtailments. Our analysis shows that it is the smaller producers who bear the brunt of block billing and thus who are most in jeopardy of being driven from the business. PEG feels justified in asking the

Commission whether long term gas supply will be adversely affected by this change in federal regulation.

In summary, the industrial user is caught in a situation where, on the one hand, he must face a fate worse than incremental pricing and on the other may have to face curtailments again. One way to mitigate this situation is to use transportation, but, as the next section will demonstrate, this is not a viable option either.

Access to Transportation Greatly Curtailed

One of the most positive elements of the natural gas market during the past two years has been the increasing role of market forces as the Commission has opened access to interstate transportation. Market forces have moderated and in some cases lowered our gas prices. 12/ Industrial consumers and local distributors have been able to buy gas at the wellhead and have it transported to them as an alternative to purchasing gas from interstate pipelines or, in the case of industrial customers, from interstate pipelines or local distribution companies. The Commission's willingness to allow transportation as well as sales in the gas market has resulted in savings for all classes of gas consumer. 13/ But Order No. 436, which was intended to

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12/ *See* Chart 3 showing the decline in spot market gas prices.

13/ *See* Chart 4 showing gas prices during the past six years.

continue the process of enhancing transportation, has, in fact, done the reverse.

Interstate pipelines now are without regulatory authority to commence moving gas to industrials or local distributors in the great majority of situations unless they seek the new blanket certificate made available under Order No. 436 or agree to allow customers to reduce firm sales entitlements or both. 14/ No interstate pipeline has apparently been willing to do this to date.

For those companies and many other PEG members who have been working to negotiate the new, market-sensitive gas supply arrangements we need to stay competitive, Order No. 436 is a step backward. We have again become captive customers of a single supplier. A return to the transportation programs in place before the issuance of Order No. 436 would be better than the current situation.

Incentives for Pipeline Participation

In our comments before the Commission when Order No. 436 was in the form of a proposed rule, we urged that pipelines be given positive incentives to transport gas. This could be done by structuring interstate pipeline transportation rates in such a way that the pipelines could expect to make a profit if they became actively involved in transportation for end-users and distributors.

14/ *See* §§ 284.10, 284.221, 284.223.

Unfortunately the final rule makes it doubtful that pipelines who participate in the new transportation program will be rewarded. 15/ At the same time, pipelines who participate are also faced with the contract demand reduction and conversion requirements many of them fear to accept. 16/ In part, at least, we believe this is the

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15/ The regulations provide that transportation costs are to be allocated and rates are to be designed on the basis of "projected levels of service." Although a transportation rate may be discounted, there is little incentive to do so, since the pipeline will meet its revenue requirements only if it transports the projected volumes at the maximum rate or makes up in volume an amount equal to its discounts. See 50 Fed. Reg. at 42452; § 284.7(d). However, if a pipeline's transportation exceeds the projected level of service, it may be penalized by having this volume increased in its next rate case because the Commission intends to subject these matters to "full regulatory scrutiny" in every rate case. 50 Fed. Reg. at 42449.

16/ Pipelines that provide non-discriminatory transportation must grant their firm customers the right to reduce their contract demand by up to 25 percent annually. See § 284.10. If a customer exercises this option, the pipeline must reduce the customer's minimum bill proportionately. See § 284.10(c)(4); on the other hand, the customer has no assurance that it can continue to purchase gas at its former rate, see § 284.10(g) (rate adjustments), or even that it will be able to increase its purchases from that supplier at some later date, see § 284.10(f) (abandonment). Furthermore, although contract demand reduction may shift fixed cost responsibility among customers of a pipeline and may also increase a pipeline's take-or-pay liability to producers, the Commission has deliberately avoided any determination as to who should bear the cost burden of unused or underused pipeline capacity. 50 Fed. Reg. at 42439, 42440-42, 42446-47. Thus, the consequence of tying the transportation program to contract demand reduction may be to discourage both pipelines and distributors from making these choices before it is possible to ascertain

[Footnote continued]

reason that no pipeline has thus far agreed to participate in the new transportation program. We hope the Commission will revise its regulations during the rehearing process to correct this problem.

Discrimination Against Industrial Consumers

Order No. 436, while being described as a step toward non-discrimination in transportation, actually provides for serious discrimination against industrial gas users. Firm gas customers are given the option to convert to firm transportation, in preference to all potential shippers, even when they are not now using the capacity. The rule gives a preference to access to firm transportation service to local distributors for they are, in almost every case, the only current, firm sales customers of the pipelines. 17/ Industrial users must line up for firm capacity, if any remains after local distributors have claimed their share. 18/

In addition, it appears that transportation for industrial end-users, if pipelines do eventually choose to accept the new blanket certificate, is subject to a single term of 120 days unless the transaction survives a protest

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[Footnote continued]
the likely cost in comparison to the theoretical benefits.

17/ Section 284.10; 50 Fed. Reg. at 42437.

18/ The Commission itself notes that "the firm capacity of most pipelines is generally contracted for." 50 Fed. Reg. at 42438.

opportunity. 19/ The protest procedure allows open season to any current supplier to seek to block out transportation through the regulatory process rather than face the competitive pressure of meeting the offers of other suppliers. 20/

Local Distribution Company Interference

Order No. 436 totally ignores one of the most serious problems that industrial users have faced in seeking to secure competitively priced gas supplies. This is refusal by local distribution companies to transport gas or imposition of prohibitive transportation rates. Local distributors secure considerable benefits from the Commission's new order. 21/ Notwithstanding these benefits, the Commission has exempted them totally from any obligation to transport gas under its rule. 22/

We believe the Commission has legal authority to 23/ and should require local distributors, as a condition

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19/ Section 284.223(a)-(c); section 157.205; 50 Fed. Reg. at 42458-59.

20/ 50 Fed. Reg. at 42458-59.

21/ For example, local distribution companies may have gas moved to them under the new blanket certificate program established by § 284.221 on a fully self-implementing basis. They may use gas transported under the new blanket certificate to retain industrial load without the barrier of the system supply requirement which formerly limited their flexibility. Section 284.221; 50 Fed. Reg. at 42457-58.

22/ 50 Fed. Reg. at 42433.

23/ The Commission acknowledges this point in its comments on Order No. 436, 50 Fed. Reg. at 42433.

to receiving the benefits of Order No. 436, to agree to transport gas on a non-discriminatory basis.

Conclusion

In its Notice of Proposed Rulemaking in this proceeding, the Commission stated that its goal was

> to make such adjustments in our regulation of interstate transportation of natural gas as are required to ensure that the natural gas markets are viably and sufficiently competitive so that consumers are provided natural gas at the lowest reasonable rates consistent with reliable long-term service. 24/

For the reasons mentioned above, Order No. 436 and the block billing proposal work against this goal. Competitive gas supplies are a necessity if our industry is to remain competitive in world markets. We would urge that the Commission be given every encouragement to correct the problems Order No. 436 has created. The Commission also should abandon its block billing proposal.

We have raised our concerns with the current rule in a petition for rehearing filed with the Commission and will point out our concerns with block billing in comments to be filed next week with the Commission. Meanwhile, we would be happy to work with this Committee to consider any means of resolving the serious problems now existing and resuming progress toward the goal described by the Commission of securing the benefits of competitive markets for all gas consumers.

24/ Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Notice of Proposed Rulemaking, FERC Docket No. RM85-1-000 (Parts A-D), (Issued May 30, 1985). Mimeo at 3.

ARCO Oil and Gas Company
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Telephone 214 880 4219

W. C. Rusnack
Senior Vice President
Marketing and Employee Relations

November 19, 1985

The Honorable Don Nickles
Chairman, Subcommittee on Energy
Regulation and Conservation of
the Committee on Energy and
Natural Resources
United States Senate
SD-306
Washington, D.C. 20515

Dear Senator Nickles:

It is our understanding that you have scheduled a hearing by the Energy Regulation and Conservation Subcommitee for November 21, 1985 to consider matters relating to the Federal Energy Regulatory Commission's Order No. 436, Docket RM85-1-000, "Final Rule and Notice Requesting Supplemental Comments". ARCO Oil and Gas Company, Division of Atlantic Richfield Company ("ARCO") desires to participate in the proceeding by submitting herewith its views on the one feature of Order No. 436, Secrion D - Block Billing, that is of major concern to us and apparently, from reading the comments submitted to the Federal Energy Regulatory Commission ("FERC"), to all segments of the natural gas industry.

ARCO respectfully requests that this letter be incorporated in the record of the Subcommittee's November 21, 1985 proceedings.

ARCO generally endorses FERC objectives of open non-discriminatory transportation as a constructive approach to dealing with current problems of interstate transportation of natural gas. However, the proposed Block-Billing mechanism concept for dealing with the problem of the old regulated gas "cushion" is cause for grave concern.

ARCO agrees that there is a problem with a market place where a portion of the commodity is sold at the supply source in a free unregulated market environment and the remainder sold in a regulated environment. Under such a system only chaos and disorder can result. The optimum solution for the Country would be to promptly deregulate all of the remaining natural gas regulated by the Natural Gas Policy Act of 1978 and the Natural Gas Act by a date certain and let the invisible hand of Adam Smith operate freely. Only Congress can do that.

Thus, we commend FERC for attempting to address these problems within the constraints of existing laws, unfortunately their solution, Block Billing, fails to accomplish these objectives. Some of the principal defects in FERC's Block Billing concept are:

.....Phantom Level Playing Field

There is no level playing field under Block Billing. The current playing field is tilted with gas supply partially regulated and partially free, but with pipelines and LDC's using rolled-in pricing at the point of sale to consumers. There are some pipelines and LDC's that are currently advantaged, while others are not. Under Block Billing the playing field is not leveled, but merely tilted in another direction with a different set of winners and losers.

The biggest loser could well be the consumer since FERC has no juridiction over how LDC's set their tariffs. Assuming a different set of LDC's gain an advantage under FERC's proposed Block Billing, there is no assurance that such benefits would be flowed on to their customers, or if flowed through, to which customers --- residential, commercial, or industrial. That decision would be the LDC's with approval of its state or local regulatory commission. So long as the old gas "cushion" exists, there will be distortions. The solution is to allow regulated old gas to reach current market clearing levels either by Congress decontrolling such gas or by FERC prescribing new just and reasonable rates, pursuant to the Natural Gas Policy Act. Then and only then would the "playing field" level out.

.....Future Adequate Gas Supply

In addition to "leveling the playing field", another benefit to the country from the deregulation of the old gas "cushion" problem would be the unlocking of additional gas reserves. A potential new gas supply is additional recoverable reserves from older (pre-1977) gas fields that could be developed by infill drilling, well stimulation, compression, etc. Office of Technology Assessment of the U.S. Congress in its report on "U.S. Natural Gas Availability", issued earlier this year, concluded that there was some 43 to 65 TCF of additional reserves potentially available from such fields. This is in line with a similar study ARCO made on the same subject in 1983 and submitted to Representative Sharp by Stuart C. Mut on April 28, 1983. These reserves will be lost when the revenue from an old well cannot pay expenses, much less support remedial work or well stimulation to recover additional gas reserves, as it will be plugged and abandoned. The proposed Block Billing concept will not provide any incentive for such action.

It would be a breach of faith and a violation of our duty and obligation to our progeny if we allow these producing gas fields to be prematurely abandoned and these potential additional recoverable reserves lost to America.

.....Time for Adequate Deliberation

ARCO is also concerned that FERC is rushing into this new and radical mechanism without taking time for reasoned, well informed analysis. When proceeding into uncharted waters it is best to proceed slowly and with caution lest the ship be beached on an unknown reef. In this proceeding, when its Notice of Proposed Rulemaking, Docket No. RM85-1 was issued last May, FERC gave parties only forty-five (45) days to comment, then when Order No. 436 was issued it gave only forty (40) days to study and submit comments on its revised proposed Block Billing concept.

On such a significant new concept the FERC would be well served if it gave all interested parties throughout the country, no matter how limited their resources, an opportunity to voice their views. As it has done in the past under similar circumstances, this could be accomplished by holding open meetings at six or so strategic geographically located cities.

We believe if FERC would not rush to judgement on this issue, but take time to give all parties adequate opportunity to perfect and submit their comments, it would be able to make a fully informed judgment.

Thank you for giving ARCO an opportunity to voice its concerns.

Sincerely,

W. C. Rusnack

PTD/skb

cc: The Honorable Mark O. Hatfield
The Honorable Pete V. Domenici
The Honorable John W. Warner
The Honorable Chic Hecht
The Honorable Daniel J. Evans
The Honorable James A. McClure
The Honorable Howard M. Metzenbaum
The Honorable Wendell W. Ford
The Honorable Bill Bradley
The Honorable Jeff Bingaman
The Honorable John D. Rockefeller IV
The Honorable J. Bennett Johnston

National
Council of
Farmer
Cooperatives

December 3, 1985

Honorable Don Nickles, Chairman
Subcommittee on Energy Regulation
and Conservation
Committee on Energy and Natural
Resources
United States Senate
Washington, D.C. 20510

RE: FERC Final Rule
Docket No. RM85-1

Dear Mr. Chairman:

The National Council of Farmer Cooperatives (National Council) would like to commend your Subcommittee for holding hearings on November 21 concerning the impact of the Federal Energy Regulatory Commission's (FERC) final rule in Docket No. RM85-1 (Order No. 436). This final rule is intended to provide the opportunity for, and indeed encourage, the transport of natural gas by interstate pipelines on behalf of non-owner shippers.

INTEREST OF THE NATIONAL COUNCIL

The National Council is an association of cooperative businesses which are owned and controlled by farmers. Our membership includes 101 major marketing and farm supply cooperatives, the 37 banks of the Farm Credit System, and 33 state councils of farmer cooperatives. The National Council represents about 90 percent of the 5,800 local farmer cooperatives in the nation, with a combined membership of nearly two million farmers.

Members of the National Council utilize natural gas for a wide variety of purposes, including the manufacture of fertilizers, food/feed processing and crop drying. Farmer-members in the cooperative system also utilize natural gas directly for crop drying, for powering of irrigation pumps and as a heat source in livestock operations. Additionally, farmers and their rural neighbors comprise an important segment of the residential sector consuming natural gas for home heating, cooking and water heating.

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202/659-1525

Serving America's Family Farmers

In light of the critical importance of natural gas to its members, the National Council has maintained an active interest in both the regulatory and legislative policy arenas ever since the shortages of 1976/77.

Conditions dominating today's natural gas market, as well as those of the foreseeable future, dictate that the FERC's transportation policies will have a major effect upon agricultural users' access to equitably priced natural gas supplies.

TRANSPORTATION POLICIES CAN REDUCE BARRIERS TO COMPETITION

A consistent natural gas supply surplus over the past several years has been slow to generate an appropriate price response due to structural/institutional barriers which have severely inhibited the operation of basic competitive forces. Demand-supply signals must move readily between those who have the need--natural gas consumers--and those who have the commodity--natural gas producers. An open and competitive natural gas transportation system represents the essential ingredient which would permit these critical market forces to operate. That is why the National Council has for the past several years actively called for legislative action which would implement mandatory contract carriage.

The National Council has also been an active participant in FERC proceedings dealing with natural gas transportation. We have consistently supported expansion of FERC transportation programs in order that gas consumers might have improved access to market-priced natural gas. The National Council commended the FERC for its actions in Docket No. RM85-1 We specifically supported the FERC's (1) non-discrimination condition, (2) the transportation rate proposals, (3) elimination of the system supply requirement for Section 311 transportation, and (4) making all natural gas supplies eligible for blanket certificate transportation.

The few modifications suggested by the National Council (open access to firm and interruptible transportation, unbundled transportation rates that reflect the cost of providing transportation, and a reasonable reservation fee for firm transportation service) were incorporated by the FERC into the final rule.

TRANSITION DIFFICULTIES

Unfortunately, the transition between the FERC's pre-November 1985 transportation rules and the Order No. 436 transportation program is generating major concern within the farmer cooperative community. Most interstate pipelines have chosen to refuse participation in any aspect of the FERC's open transportation program, and only a few pipelines committed to non-discriminatory transportation during the interim 45-day period (November 1 - December 15, 1985).

The FERC's transitional rules allowing transportation of natural gas on the interstate pipeline system are proving to fall short of meeting agricultural end users' needs. The end result is that many agricultural end users are being restricted to higher-cost system gas.

The agricultural community has been placed at serious risk by the combination of circumstances which have led the pipelines to refuse to participate in voluntary carriage. Agriculture is in the midst of an unprecedented economic crisis, and can ill-afford new problems of this nature. The National Council is hopeful that the pipelines will accept the Order No. 436 program in the near future, so that the benefits of gas transportation may be made accessible to all consumers. We appreciate any application of this Subcommittee's persuasive powers in accomplishing that end result.

S. RES. 255

The National Council commends this Subcommittee Chairman for introducing Senate Resolution No. 255, as a means of highlighting the seriousness of the problem. However, we would have preferred that the Resolution place a greater challenge directly upon the pipelines to implement an open transportation system in a positive manner. The wording appears to place the entire burden for any corrective action upon the FERC. The National Council would reiterate that we are highly supportive of FERC actions to date. Although certainly there may exist some opportunity for the FERC to make a few adjustments, the ultimate success or failure of this voluntary program lies in the hands of the pipelines.

It is unfortunate that the November 21 hearing schedule could not be adjusted to accommodate our request to testify. Should that Hearing Record remain open, the National Council would request that this communication be included as part of the record.

Respectfully submitted,

R. Thomas Van Arsdall

R. Thomas Van Arsdall
Vice President
Agricultural Inputs and Services

RTVA:sn

cc: Committee on Energy & Natural Resources Chairman
James A. McClure
Committee on Energy & Natural Resources Ranking
Minority Member J. Bennett Johnston

PHILLIPS PETROLEUM COMPANY
WASHINGTON, D.C. 20006
SUITE 1107 1825 K STREET, N.W.

December 9, 1985

The Honorable Don Nickles
Chairman, Energy Regulations and
Conservation Subcommittee
212 Hart Senate Office Building
Washington, D. C. 20510

Dear Senator Nickles:

During your recent Subcommittee hearing in Tulsa on FERC's Notice of Proposed Rulemaking, you requested more specific information on the loss of gas markets resulting from the recent transportation changes. Attached is additional information on such gas which has been produced by Phillips in Oklahoma and Texas.

Phillips' Gas and Gas Liquids Group has indicated that alternate markets have been found for a large amount of the gas volumes, however, alternate sales were at much lower prices.

Again, our opportunity to provide input into this issue is appreciated.

Sincerely,

Don

Don R. Duncan
Federal Regulations
Representative

DRDgn
Attachment

GAS PRODUCED IN OKLAHOMA

Transporter:

Panhandle Eastern Pipe Line Company

Customers:	Volumes:
Yankee Resources	36 MMcfd
Allied Paper	4 MMcfd
Citizens Gas & Coke	11 MMcfd
Reliance Pipeline	20 MMcfd
State Gas	5 MMcfd
Delta Resources	1 MMcfd
Total Market Lost in Oklahoma:	77 MMcfd

GAS PRODUCED IN TEXAS

Transporters:

El Paso Natural Gas Co.
Panhandle Eastern Pipe Line Co.
ANR Pipeline Co.

Customers:	Volumes:
Phelps Dodge	19 MMcfd
Magma Copper	14 MMcfd
Reliance	29 MMcfd
Panhandle Trading	1 MMcfd
Yankee Resources	30 MMcfd
Total Market Lost in Texas:	93 MMcfd
Total Market Lost in Both States:	170 MMcfd